

NEW ZEALAND BUSINESS ROUNDTABLE

**SUBMISSION
ON THE CONSULTATION DOCUMENT
*BETTER TRANSPORT BETTER ROADS***

APRIL 1999

Overview and Recommendations

Overview

- 1 This submission on the government's consultation document *Better Transport Better Roads* (the Document) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall national interests.
- 2 The NZBR strongly supports the government's broad approach to road reform in recent years. We have done so because the road network is an important part of the nation's infrastructure and we believe that substantial efficiency gains can be achieved by reforming its management.
- 3 We agree with the Document's view that significant efficiency gains should be achievable from better investment decisions, a better balance between roading expenditures and willingness to pay, less congestion, and greater safety. We strongly agree with Document that moves to a more commercial environment are necessary in order to maximise the likely net gains.
- 4 More particularly, we agree with the following other explicit or implicit assumptions and provisions in the Document:
 - continuing government ownership of the proposed road companies is necessary initially;
 - initially it is sensible to have at least one company that focuses on providing long-haul (state highway) road services;
 - significant monopoly issues arise in parts of the network;
 - road providers should be able to borrow to fund capital works;
 - road providers should be responsible for all aspects of road safety; and

- efficient prices must cover current and future costs rather than sunk (past) costs.

5 However, as explained in section 2 of this submission, many specific proposals concern us. These concerns encompass broad structural issues relating to governance and the clarity of property rights, and many specific regulatory provisions that directly affect incentives to price efficiently, control costs and invest optimally. In our view, compared with realistic alternative arrangements, the detailed proposals:

- unduly deny the benefits of private ownership and competition when these are essential if the full potential efficiency gains are to be obtained;
- unduly and undesirably rely on government-owned statutory monopoly providers;
- entrench too many privileges in relation to local authorities, Transfund, users of buses and trains, safety regulators, and Maori;
- provide too much scope for local authorities to use their shareholding interests and regulatory powers for discriminatory and anti-competitive political purposes;
- fail to solve the problem of a Transfund that lacks the information and strong incentives necessary to promote economic efficiency, and lacks accountability for efficiency losses because it can always say that its decisions are in accord with some conflicting objective. Transfund also has an incentive to inhibit competitive entry in order to protect its position;
- put too much reliance on state ownership and intrusive regulation for the control of monopoly and other problems;
- unduly impair the clarity of property rights by imposing too many ill-defined and potentially open-ended obligations on road providers; and

- impose revenue and property constraints that could easily conflict with efficient pricing principles and allocative and productive efficiency.

6 In section 3 we consider monopoly issues in order to assess whether the measures that are envisaged represent an efficient response to a competition policy problem. In our view, monopoly problems are most serious in respect of local commuter, CBD and link roads. We do not see significant monopoly problems in respect of major state highway corridors that face competition from rail, sea and air. This leads us to suggest that the commercialisation of Transit New Zealand should proceed regardless of the timetable for local roads. Similarly, there does not appear to be a monopoly problem with the pricing of local uncongested access roads since competitive charges for the supply of road maintenance services can be readily determined by competitive tender.

7 Finally, in section 4, we discuss the need for government commitment to remove privileges if the efficiency benefits from reform are to be achieved. We express the opinion that stronger resolve appears to be required in this respect.

8 After considering options for addressing the monopoly problems of concern and the weaknesses we have identified with the current proposals, we express the view that greater efficiency gains could be expected if, in broad terms, the government and officials were to:

- show greater determination to remove privileged positions, particularly in relation to Transfund, local authorities, buses and those making use of local public goods;
- explicitly acknowledge the critical importance of competitive entry and private ownership and actively seek opportunities to remove roads from the current statutory monopoly supplier framework;

- do more to promote private sector participation in roads on a piece-wise decentralised basis, as is occurring in the United States. While the current proposals perhaps necessarily have some of the elements a monolithic, central planning, statutory monopoly approach, the importance of allowing private sector participation to emerge spontaneously on a decentralised basis should also be acknowledged and built into the current framework;
- explicitly acknowledge that monopoly concerns vary across the network and that contracting can help alleviate monopoly problems;
- rely much less on regulation of congestion prices, non-use-related prices and total revenues to address monopoly concerns, and rely more on measures that are much more focused on the particular routes that raise the greatest monopoly concerns; and
- explore instead measures that focus on better control of government-owned road companies and on issues of ownership, competition, and competitive contracting for the routes raising the greatest concerns.

Recommendations

We offer the following specific suggestions for improvements to the package of measures proposed in the Document.

Private sector participation

- Competition is critical to longer-term efficiency gains, including the undermining of monopoly situations. Opportunities should be sought and taken to increase private participation in the provision of roads on an incremental basis, rather than relying on the 'big bang' approach at some future date of selling a major state-owned road company.
- Greater weight should be put on the desirability of dispersed ownership of competing road segments. Opportunities to diversify the ownership or control of specific routes where monopoly concerns are the greatest should be investigated, perhaps by the proposed

Establishment Commission, prior to the formation of these companies. Furthermore, the proposed road companies should be permitted to divest portions of their roads to new road owners.

Governance of the proposed road companies

- The Crown should hold shares in the local road companies in order to help protect against monopoly pricing, anti-competitive practices and politically motivated discriminatory pricing.
- Road companies should have the single goal of shareholder value maximisation, subject to compliance with all laws and regulations and the requirement that they do not achieve their profits by the abuse of an dominant position.
- Road companies must be permitted to make losses or supernormal profits, depending on luck or skill, as long as profits are not achieved by the abuse of a dominant position.
- The Crown should retain an explicit ability to require local authorities in the future to divest their shares and to enable the companies they own to divest assets, in order to promote competition and efficiency.
- The Crown should also consider splitting the state highway company geographically (eg North and South Islands) in order to permit diverse entrepreneurial views about the optimal future arrangements on parts of the network, rather than have one view prevail across the entire state highway system.
- Proposals that impair the clarity of road company property rights, such as those listed in section 2.2, should be carefully examined to determine if:
 - (i) they are really necessary or desirable;
 - (ii) they reflect transitional or possibly temporary factors, in which case time-limited structures may be more appropriate; and
 - (iii) it is undesirable to apply them to all road companies or to all parts of the network.

Pricing proposals

- The proposed pricing structures, particularly for access roads, should permit recovery of non-use-related expenses from access-related periodic payments, is the practice with electricity and telecommunications line companies, mobile phone operators and Sky Television.
- Revenues from congestion charges should be permitted to increase total revenues and to thereby fund improvements to the road infrastructure.
- Motorists should not be taxed in order to cross-subsidise buses, trains or other non-motorist groups. Subsidies should be transparent. Public goods should be either provided and funded voluntarily, as a bundled product, or, where central or local government mandates the volume of provision in the general public interest, funded from general or local taxation.

Monopoly

- In the transition, before competition for local roads is manifest and pricing norms established and widely accepted, the Crown should rely on direct, route-specific and user-group-specific measures for preventing abuse of a dominant position. It should not impose blanket controls on total revenues. In particular, the Crown should:
 - be a shareholder in the proposed local road companies;
 - consider requiring its shareholding directors to certify that they are satisfied that the local road companies' strategic plans do not represent an abuse of a dominant position from a competition policy perspective and in terms of cross-subsidies for particular groups;
 - investigate in detail the opportunities for minimising the degree to which the proposed local road companies own all competing short-haul routes involving major traffic flows. Routes that the dominant local road company is thereby

excluded from owning or controlling could be owned or controlled by other road companies or by private investors. One option would be to tender the franchise to operate the route to the bidder who will maintain it, and enhance its capacity as specified, at least cost;

- investigate similar options for easing transitional concerns about single routes that appear to constitute a material local monopoly for geographic reasons, perhaps by tendering the franchise to operate those roads at least cost. The dominant local road company could be a bidder;
 - retain indefinitely the right to require local government-owned road companies to divest or franchise local feeder, link or other roads that present material monopoly concerns; and
 - consider measures that would increase its ability to ensure that regulatory processes which determine approvals for private sector proposals to build new local roads that would compete with those of the local authority road company are not used for anti-competitive purposes by local authorities.
- A date should be set for reviewing the appropriateness of whatever regulations are imposed on the formation of the road companies, with a view to removing regulations whose benefits were largely transitional.

Transfund

- It should be made absolutely clear to Transfund that it is to have no ongoing role. Furthermore, any transitional role should be explicitly time-limited.
- Transfund should be given no opportunity to use administrative or other processes to delay the entry of alternative purchasers.
- Because of Transfund's conflict of interests, consideration should also be given to making the Ministry of Transport, rather than Transfund,

responsible for recommending (shadow price) rules for initially allocating revenues between the proposed road companies.

Regulatory Impact Statement

- Cabinet Office Circular (98) 5 requires new regulatory proposals to: (1) clearly state the problem in a way that establishes a need for government action; (2) determine an objective of the regulation that is not chosen so as to pre-justify the proposed effects; (3) set out feasible options for achieving the desired objective; and (4) identify the total regulatory costs and benefits of the proposals and the alternatives. This discipline should be adhered to when any regulatory proposals arising out of the reform package are put to ministers.

1 Introduction

- 1.1 This submission on the government's consultation document: *Better Transport Better Roads* (the Document) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall national interests.
- 1.2 The NZBR has taken a close interest in road reform issues since publishing, in June 1993, a report by CS First Boston on *Options for the Reform of Roothing*. We have made submissions on all the major official discussion documents in recent years on road pricing and road reform. Our most recent contribution was a February 1998 submission on the Roothing Advisory Group's December 1997 discussion document *Road Reform: The Way Forward*. Many of the comments made in that submission, for example those applying to ownership and regulation, apply to the current proposals. For this reason a copy of our February 1998 submission is also enclosed.
- 1.3 The NZBR strongly supports the government's broad approach to road reform in recent years. We have done so because the road network is an important part of the nation's infrastructure and we believe that substantial

efficiency gains can be achieved by reforming its management. However, there are many reasons why road reform efforts could prove disappointing.

- 1.4 In section 2 we explain why we think that the current proposals will fail to provide anything like the achievable benefits from road reform. Too many efficiency-reducing restrictions are being proposed in relation to governance, investment, property rights and pricing.
- 1.5 Concerns about the potential for monopoly pricing may be motivating many of these restrictions. We discuss this issue in section 3.
- 1.6 Section 4 makes some concluding comments on the issue of building constituencies for more promising reform structures.

2 Threats to efficiency inherent in the proposed measures

2.1 Introduction

- 2.1.1 We strongly support the key proposals in the Document to put road providers into commercial structures and to make them primarily responsible for all aspects of safety. We see these as essential first steps towards the desired efficiency gains.
- 2.1.2 Given that roads are not a public good, we have a strong view that private ownership and competition in the supply of roads and the removal of statutory privileges provide the best longer-term solutions to problems of monopoly and inefficiency. We use this perspective to assess whether specific features of the structures and constraints proposed in the Document are likely to assist or impede the evolution to more competitive arrangements.
- 2.1.3 We do not have strong views about some features of the proposals, such as the optimal number of road companies. In our view, the critical question to

ask here is whether what is proposed will assist new companies to enter the market and existing companies to disinvest or aggregate efficiently according to evolving circumstances. We agree that it is sensible to start with Transit New Zealand as one of the initial road companies.

- 2.1.4 Stressing the importance of competition, this section argues that too many provisions in the Document are likely to undermine efficiency compared with the alternative of a more commercial structure with clearer incentives, better-defined property rights and greater reliance on light-handed regulation. It concludes that the cumulative adverse effects of the proposed measures appear to be serious and avoidable.

2.2 Governance

- 2.2.1 The proposed governance arrangements embody weaknesses in respect of the ownership, objectives and clarity of property rights of the proposed road companies, and the role of Transfund. Some of these flaws are major. We discuss each in turn.

Ownership

- 2.2.2 The Document states that road companies will not be privatised. We agree that the current absence of a direct billing system for use of any part of the network by cars reduces the potential gains from private ownership. Initially, some administrative process or procedure must be used to allocate revenues to the individual road companies. That mechanism has the potential to distort investment decisions compared with the prospective direct billing technologies. Some private toll roads may still be possible.
- 2.2.3 Yet ownership matters for efficiency. Private ownership is necessary for full competition. The essence of a market system is private ownership. Investment and pricing decisions are fundamentally entrepreneurial and subjective. Only a competitive market environment allows the contest between different views as to what is efficient to be determined by the jury

that comprises all users. Only the prices and investments that emerge successfully from this contest will have passed the test of market efficiency.

- 2.2.4 In contrast, the prices set and the investment decisions made by statutory monopolies do not emerge spontaneously from a market contest. They thereby lack its efficiency attributes. Government agencies required to act as entrepreneurs lack the discipline that markets impose on private entrepreneurs. They are less likely to make sound commercial investment decisions and when a decision is found to be a mistake, political considerations will interfere with the commercial need for timely corrective action. Banks and bondholders will put less pressure on a government-owned entity to perform than they would on a private firm; their attitudes will be affected by the extent to which they think the government-owned firm is underwritten by the government's powers of taxation.
- 2.2.5 Excessive costs and cross-subsidies for politically preferred groups are an ever-present problem under government ownership when competition is limited. Typically, government-owned utilities have subsidised voting households at the expense of business customers. While a profit-maximisation objective should provide some incentive to reduce losses on subsidised outputs, competitive entry that 'cream skims' customers who are being over-charged provides the most salutary potential discipline.
- 2.2.6 Government ownership may also create a conflict of interest with regulatory responsibilities. Statutory monopolies may well lobby to preserve or raise entry barriers. Regulators may fear that multiple providers will complicate their tasks undesirably. There is a risk that local authorities will make regulatory decisions that have the effect of sheltering a state monopoly from competition so that profits can be made for the benefit of politically important groups.
- 2.2.7 The NZBR has no confidence in the ability of local authorities to act commercially or to withstand pressures to use new pricing or taxation discretions to create privileges. There is ample evidence of a widespread

anti-business bias in local authority allocations of rating burdens to businesses, and in their use of the fallacious argument that businesses can afford to pay higher rates because business expenses are tax deductible. Similarly, the arguments against privatisation that some major local authorities have made over the years are all too often self-serving and ideological. Furthermore, the spurious nature of some local authority arguments in favour of taxing motorists in order to subsidise buses and against expanding road capacity suggests an anti-motorist bias.

2.2.8 In the past we have opposed the concept of regional petrol taxes because of the concerns expressed in the previous paragraph. Currently, rating differentials aside, the problem is essentially academic at the local government level because local authorities cannot set congestion prices, road user charges, petrol prices or car registration fees so as to tax business or commercial users in order to cross-subsidise buses, pedestrians, local residents or any other influential constituency. But in the new structure local authority-owned road companies will presumably be responsible for proposing pricing structures that will allocate common costs across different types of road users. In a statutory monopoly situation, the allocation will be arbitrary (in a competitive situation, the allocation is that which can be sustained in the market). This means that it will be inherently political. While Transfund will have a role to play, that role will also be inherently political because of the incentive problems that arise from conflicting objectives (see below). Of course, current road pricing structures are politically determined by central government and central government must still set all the proposed charges and levies. The only really new element here is that local authorities are to have a direct say, through a shareholding interest, in the processes that determine the outcome.

2.2.9 For these reasons we suggest that greater consideration be given in the proposed structure to ways of addressing the conflict that shareholding local authorities will face between efficiency and wealth redistribution. There are many possibilities. Perhaps local authority shareholders should not be permitted to take part in discussions about price differentials. Arguably, the

proposed large road companies may reduce the influence of any one local authority. By themselves, however, they imply single ownership of all potentially competing local road segments. Conversely, local authorities could be prohibited from having a shareholding in any road companies that own small parts of the local network. In our view the Crown needs to establish and retain the right to require local authorities to divest their shares in road companies at some future date and to require government-owned local road companies to divest particular routes.

2.2.10 The Document rules out another possible approach to the problem by indicating that the Crown will not be a shareholder in the local road companies. However, in our view the Crown would be a much more effective shareholder in the road companies than representatives of local authorities, even if it were only a minority shareholder. We are aware of the argument that the Crown should not be a shareholder in local roads because of the commercial risks to taxpayers. However, this is clearly not a national interest argument. The Crown is responsible not just for the risks to which it exposes citizens as taxpayers, but also for the risks to which it exposes them as ratepayers and, more particularly, consumers.

2.2.11 As already noted, the ultimate solution to the problem is provided by private ownership and competitive entry. In our view, all opportunities should be explored for increasing private sector ownership and provision of roads. Opportunities should be sought to allow private companies to build and own new roads and to take over unwanted public roads. Individual road segments could be sold, leased or franchised to private operators so as to increase the competition for the alternative routes offered by the proposed local road companies. Indeed, the possibility should be considered of providing for the mandatory sale, lease or franchise of road segments owned by government road companies where a properly constituted authority determined that this could be justified on competition policy grounds. Where there are, for example, alternative routes connecting a city centre to an airport, or one state highway to another, the desirability of only permitting a

statutory monopoly company to own all the alternative routes is highly questionable.

2.2.12 It is also possible that some of those residing along local rural or urban access roads would prefer to own those roads. Roth reports, for example, that many rural access roads in Sweden are privately owned and that private ownership of streets is common in St Louis and in new commercial and residential developments.¹ In our view, it is desirable that public policy towards ownership of local access roads by (often non-profit) clubs should be permissive rather than prescriptive. Local autonomy has genuine advantages, but the coordination and incentive problems in club situations are also real. However, allowing those living alongside access roads the option of buying back the responsibility for managing them could provide a useful discipline on a local road company. Certainly, private ownership of new subdivision roads should be permitted, and it is hard to see any grounds for regulating charges for those roads.

2.2.13 The greater the scope for and diversity of private ownership and provision of roads, the greater the potential for competitive processes to curtail monopoly and discover efficient prices. While these comments look ahead further than government policy currently contemplates, it is important that reform measures make it easier rather than harder to move in this direction in the future.

2.2.14 The greatest potential threat to competition in the supply of roads arises from the creation of statutory monopolies. In our view, all statutory monopolies are suspect, but those owned or controlled by local authorities are likely to be particularly discriminatory, anti-competitive and uncommercial.

Lack of clarity in property rights

¹ Gabriel Roth, *Roads in a Market Economy*, Avebury Technical, 1998, pp viii-272, at p 165.

2.2.15 The following is an (incomplete) list of features of the proposals that create uncertainty as to the property rights of the proposed road companies:

- the requirement to negotiate in 'good faith' (see page 64);
- the requirement to consult with Maori (see page 48);
- the proposals to give communities 'meaningful input' into how road corridors are developed and used (page 49);
- possible uncertainty as to who is to pay for amenities not managed by local authorities;
- the requirement to conform with pricing principles and with requirements that have the potential to violate those principles;
- the implications of the proposed pricing principles for allowable prices;
- the proposed requirement to amend the Resource Management Act in order to impose a duty to avoid *unreasonable* noise and avoid, remedy or mitigate *adverse* affects (see page 47, emphasis added); and
- the apparent conflict between the prohibition on road companies owning or participating in non-related businesses and assets and their ability to enter joint ventures (see page 32).

2.2.16 No doubt many uncertainties in the assignment of property rights cannot be avoided given the current state of our laws. However, not all these provisions appear to fall into that category.

2.2.17 We suggest that such requirements be carefully examined to determine if:

- they are really necessary or desirable;
- they reflect transitional or possibly temporary factors, in which case time-limited structures may be more appropriate; and

- it is undesirable to apply them to all road companies or to all parts of the network.

Objectives for the road companies

- 2.2.18 The Document sets out four principal objectives for the new road companies. The first – to operate as successful businesses – should be redundant. The second – to be as profitable and efficient as comparable non-public businesses – denies the companies the incentive to reduce costs or to maximise shareholder value beyond this (imprecise) point. Unlike the objective of maximising shareholder value, this objective invokes the concept of rate of return regulation. This is because it seems likely to focus attention on the road company's rate of return on the book value of its assets compared with those of 'comparable non-public businesses'. The third would be redundant in a healthy commercial environment – firms that have to proclaim that they are good employers thereby provide evidence to the contrary. The fourth – to exhibit a sense of social responsibility – is so unclear and subjective as to raise potentially serious problems of accountability. This objective seems likely to conflict with the other three objectives, yet no basis is provided for resolving such conflicts. In such circumstances any decision on the trade-off is as good as any other decision.
- 2.2.19 Having said this, we acknowledge that the choice of objective is a difficult one. In a conventional commercial situation, the logical objective would be shareholder value maximisation subject, of course, to compliance with all laws, including the Commerce Act. In the absence of a secondary market in the company's shares, the lack of an observable share price makes the company's performance in respect of this objective difficult to assess. Too much emphasis on maximising current profits invites under-spending and over-pricing. The difficulties are compounded by the reality that, at least initially, revenue is derived from a tax on fuel which is a highly imperfect proxy for the value supplied by the road company. It would be undesirable

for road companies to design roads that aimed to maximise profits from fuel consumption.

2.2.20 A single objective of value maximisation, subject to the Commerce Act, also raises a question about the adequacy of such provisions to control a road provider's attempts to make monopoly profits by equating marginal revenue, rather than price, to marginal cost. This is technically a very difficult issue because marginal cost is unobservable and pricing above marginal cost may be efficient when common costs must be recovered, and in the case of congestion charges. (In the case of congestion charges, charging at the opportunity cost of the marginal motorist is indicated.) The difficulties loom largest in the transitional period when competitive entry has not occurred and pricing norms have not been established for the new direct billing technologies.

2.2.21 These difficulties undoubtedly complicate the process of achieving a transition to a more competitive and commercial structure. It is difficult to avoid the conclusion that for a transitional period the government will have to play a greater role than would normally be desirable in ensuring that road companies' corporate and strategic plans do not constitute an abuse of a dominant position. The Document acknowledges this in pointing out that the setting of petrol excise and motor vehicle licence duties has to remain a government responsibility. While government-owned road companies can be instructed to pursue value maximisation subject to specified constraints, the government must retain responsibility for ensuring that those constraints are being observed. In our view this increases the case for a Crown shareholding in the local road companies during the transitional period.

2.2.22 This analysis leads us to suggest that the proposed companies be given a single, clear, value-maximisation objective, but that its pursuit be made subject to conformity with constraints which aim to minimise the problems that might otherwise arise from monopoly and from the distortions resulting from the absence of a conventional billing system. Clearly it is going to take some years to achieve a conventional commercial environment although the

transition for trucks should be speedy. The decisions as to when to invest in new billing technologies, which technologies to adopt, how to price them and how quickly to introduce them are fundamentally entrepreneurial. The more commercial is the environment, the stronger will be the pressures to take commercial decisions.

2.2.23 Having made these criticisms of the proposed objectives, we acknowledge that their weaknesses are also inherent in the State-Owned Enterprises Act. However, they can be expected to be more important in reducing efficiency the less competitive is the market in which the state-owned enterprise is operating and the greater the pressure on the SOE from special interests to sacrifice efficiency in order to promote a self-serving concept of 'social responsibility'. Environmental, safety, and free rider issues in relation to pedestrians and cyclists suggest that road companies will be relatively vulnerable in this respect.

Transfund

2.2.24 Efficiency depends on the ability of road providers to determine road user requirements and meet them at least cost. Providers experiment with price/quality options and assess user reactions. This is an intricate, subjective, dynamic and information-intensive process.

2.2.25 The logic of the commercial model is that road providers should bill road users directly for services provided. Whatever its merits in a departmental purchasing model or as a transitional device until direct billing systems are put in place, Transfund has no valid role in a commercial structure. It has no comparative advantage in information. It cannot hope to understand either road user preferences or road supplier constraints and costs as well as road users and road providers. It can only impair the information flows between road users and providers.

2.2.26 Reflecting its information problems, Transfund will be largely unaccountable for its actions. It can escape the market discipline of an entrepreneur because

it cannot be given a clear, profit-maximising objective as long as it can simply meet any such objective by spending less. As a monopoly purchaser with an assured revenue stream, it could easily succumb to the temptation to increase its own power and prestige at the expense of the road companies' budgets and ability to deliver. Road users would not be sure whether to blame Transfund or the road companies for any dissatisfaction. It is conceivable that this structure could lead to the same level of voter dissatisfaction with the proposed road reforms as has occurred with the health reforms.

2.2.27 Lacking a clear, single (profit-maximisation) objective, Transfund will inevitably behave as a political, bureaucratic institution. Its purchasing decisions will be a compromise between conflicting pressures from diverse users, interest groups, environmental and safety interests. Formally, any decision it makes would be as good as any other decision when there is no objective basis for trading off conflicting objectives. The only real accountability will be political, according to political criteria. This is the accountability of pressure group politics. Efficiency will be compromised. The pricing and investment decisions that Transfund sanctions will not be efficient, except by remote chance.

2.2.28 Even in the transition, Transfund poses a clear potential threat to the development of competition. This arises when it can use its dominant position as a funder to raise the costs of those who might attempt to negotiate directly with a road provider. Transfund can be expected to argue that any price that would otherwise be agreed to between a road provider and a non-Transfund purchaser allocates an insufficient proportion of common costs to the competing purchaser. Given that the allocation of common costs will be largely arbitrary until competitive constraints on pricing are better established, any such argument is easy to make and difficult to rebut or resolve. Nor will Transfund face the normal commercial incentives to bring a fundamentally irreconcilable dispute to a conclusion. For these reasons, it is important that Transfund is not given anything approaching veto power over the terms a competing purchaser might negotiate with a road provider.

2.2.29 However, the most important requirement is that Transfund is left in no doubt that it has no future role as a purchaser once an interim allocation mechanism is established.

2.2.30 Notwithstanding the above points, there must be transitional arrangements for allocating money from motorists amongst the proposed road companies. The 1993 CS First Boston report suggested shadow tolling. Possibly petrol levies and registration or licence fees could be recorded geographically and allocated geographically. However, road user charges may be less amenable to this procedure and the state highways do not fit the model because they are geographically dispersed.

2.2.31 Whatever the interim allocation mechanism, it will be crude compared with the allocation that results from direct billing and negotiated interconnection revenue-sharing rules. Being crude, incentives will be commensurately weak. Given that Transfund exists, it could be asked to propose a transitional allocation mechanism. Relatively mechanistic but objective allocation rules may or may not be preferable to discretionary administrative mechanisms. The former promise lower transaction costs once the rules are established and arguably less rent seeking, at a cost of less flexibility. The danger with involving Transfund in these issues is that it may be biased in favour of options that are likely to maximise its current and future role. There would be less risk of this if it were in no doubt that it did not have a future role, but this is not currently the case. Arguably, it would be better to make the Ministry of Transport responsible for recommending the interim revenue-sharing arrangements.

2.3 Threats to Dynamic Efficiency

2.3.1 Section 2.1 argues that threats to dynamic efficiency arise from the proposed governance arrangements. However, other provisions in the Document pose an even greater threat to dynamic efficiency. For example:

- on page 13, the Document provides that "... road companies cannot earn more on a new investment than its full cost". However, if road operators can lose from new investments but never win, no new investment can be commercial;
- on page 11, the Document prohibits the use of congestion charges to increase revenue. This removes a source of funding for new investment and raises a question as to how the costs of investment are to be recouped at all. No such provision is considered sensible in respect of other network industries, such as electricity and telecommunications;
- also on page 11, the Document precludes any use of congestion charges to produce a profit that compensates the road company for the risk of loss;
- on pages 49ff, the Document provides for local authorities to be able to represent community interests. The discussion in relation to public space developments does cover the issue of compensation for any takings, but the discussion on amenities that can be taken back by local government at any time does not cover the issue of compensation for any enhancements to their value. Some of these provisions are unclear as to whether they require road companies to maintain assets of a public good nature (eg cycle lanes) on a non-commercial basis. Transparent payments for the costs of providing public goods may lead to greater efficiencies than requirements to maintain them that have the character of hidden taxes; and
- while there is provision for the degradation of uneconomic roads within safety limits and closure under existing procedures, the pledge to retain all existing roads denies local communities the freedom to make these decisions. In the absence of explicit subsidies, such a provision will either force hidden cross-subsidies or explicit subsidies. The need to fund hidden cross-subsidies will both invite competitive entry and complicate revenue-sharing arrangements – as the experience with Telecom's Kiwi share illustrates. Those with premises alongside uneconomic roads should surely be permitted to take them over.

2.3.2 Of this list, the first may represent the most serious threat to dynamic efficiency. It is essential that there be scope for supernormal profits and losses on entrepreneurial investments.

2.4 Threats to Allocative Efficiency

2.4.1 We are pleased that earlier proposals to impose a cost recovery component on prices appear to have been dropped. The focus is now more clearly on the achievement of efficient prices.

2.4.2 Allocative inefficiencies arise if prices fail to track marginal cost efficiently. Threats to allocative efficiency in the proposals arise from:

- the continuing reluctance to contemplate two-tier pricing when 40-60 percent of the costs of road maintenance are said to be non-use-related;²
- the apparent conflict between efficiency-based pricing principles and the obligation to lower other prices, regardless of efficiency considerations, when congestion charges are introduced or increased;
- the scope that the proposals appear to provide for the use of command and control environmental and safety measures which are unlikely to equate marginal benefit and marginal cost;
- the scope the proposals appear to provide to tax road users for the provision of public good services to pedestrians and cyclists and public good levels of enforcement of parking and other laws;
- the proposed 'tied tax' element to safety expenses (see page 44); and
- the proposal to permit motorists to be taxed to subsidise public transport (see page 37).

2.4.3 The first point here is potentially very important for allocative efficiency. If all costs are to be recovered from use-related charges yet a significant portion of costs are not use-related, then roads will be under-utilised. Given that

² Roth, *op cit*, p 129 supports, for uncongested roads, the use of annual licence fees in relation to maintenance and operating costs that do not relate to distance travelled. The 40-60 percent figure is from p 68 of the Ministry of Transport's May 1997 Land Transport Pricing Study Discussion Document *Options for the Future*.

most New Zealand roads are uncongested, this is wasteful. We note that there is provision for cost recovery through a vehicle levy (see page 34), but the examples of what is proposed on pages 58-60 of the document suggest that there is no intention to use this mechanism to fund non-use-related expenses. The Document does not make the case for reducing the non-use-related element of charges. This is a serious deficiency because unless it can make this case it cannot claim efficiency advantages for the proposed greater reliance on use-related revenues. Nor is it obvious that a vehicle levy is a more efficient way of funding non-use-related costs than are premise-based payments such as rates.

2.4.4 The NZBR favours removing responsibility for rating for local roads from local authorities given their conflicts of interest and their notable weaknesses. But this does not mean that road companies should not be able to offer road maintenance contracts to those with premises alongside access roads, for example, for fixed annual, monthly or weekly payments. Such fixed-price contracts could include an insurance component where, for example, flooding and land-slips are real risks. Given that fixed monthly payments are accepted in other network industries, such as electricity and telecommunications, the efficiency case for ruling out this option is hard to fathom.

2.4.5 The issue of the optimal funding of enforcement, safety, environmental, pedestrian and cycling-related expenses also needs careful consideration. Road companies may well voluntarily bundle the provision of public goods and private goods, as the much-cited supermarket car-park example illustrates. But obliging a road company to fund the provision of public goods or to provide safety or environmental services that are deemed to be required for the common good raises issues of optimal taxation. Discriminatory and inefficient taxes on road users will undermine the efficiency advantages of a move to a more commercial pricing structure. Greater efficiency gains may be achievable with more transparent funding mechanisms.

2.4.6 In respect of the enforcement of rules that are imposed in the general public interest, it is a responsibility of the Commissioner of Police to allocate police resources to the enforcement of the laws of the land. This public good role is arguably best funded from general taxation since all benefit if laws are enforced. In contrast, those who collect revenue from parking meters can determine how much of their own money to spend detecting those who seek to cheat them of revenue, just as individual shopkeepers determine for themselves how much to spend detecting shop-lifting. The boundary line between the enforcement that should be funded from general taxation and that which should be funded privately can be difficult to determine. In a club good situation, regulations that facilitate the enforcement of rules that members support for their mutual benefit can be funded efficiently by members collectively – as long as the rules are responsive to willingness to pay voluntarily. Where members must pay regardless of the benefits they derive as a whole, the coercive element implies a public good motivation and the possible optimality of some funding from general government revenues.

2.4.7 Some elaboration on the last bullet point in paragraph 2.39 above may also be useful given the frequency with which the argument for taxing motorists to subsidise buses is encountered in New Zealand. The argument that subsidies for buses and trains benefit motorists by making roads less congested lacks symmetry. Why could motorists not argue in return that subsidies for motorists would benefit users of buses and trains by making these services less congested at peak times? Both arguments simply beg the question as to why each service does not provide the optimal capacity and price it appropriately in the first place. After, all we do not entertain the proposition that patrons of McDonald's restaurants should be taxed in order to subsidise patrons of Burger King, thereby allowing McDonald's restaurants to be less frenetic in rush hour. In the fullness of time, road capacity has to be adjusted to vehicle densities regardless of bus or train densities. (Population growth forces capacity adjustments in any case.) At this point, any congestion-based case for a bus or train subsidy to reduce densities vanishes. Furthermore, direct congestion pricing (which is necessary for many of the postulated benefits from the reforms) removes

even the very weak case for bus and train subsidies as an interim measure for alleviating congestion.

2.4.8 Putting these conceptual points to one side, there is also an empirical question as to whether bus subsidies do in fact reduce peak period congestion. Subsidies for buses subsidise all who use buses, even those who would otherwise have been pedestrians, used bicycles or scooters, car-pooled, or not traveled at all. Those arguing for bus subsidies need to provide evidence that road use declines rather than increases with an increase in bus subsidies. Furthermore, the argument that motorists benefit must also take into account the extent to which buses impede traffic flows because of their size, the frequency with which they stop and re-enter traffic and their slow average speed. (Arguments for subsidies for trains take us back to the McDonald's/Burger King point.

2.5 Threats to productive efficiency

2.5.1 The proposal on page 13 of the Statement that "returns from the existing road network are constrained to current levels" would appear to remove all incentives to reduce the costs of the existing road network below the level that is consistent with this constraint. This provision could reduce the hoped-for gains in efficiency, although the requirement to tender all maintenance and capital work limits the potential losses.

2.5.2 Efficient prices will track current and future costs. What happens to revenue (and profit) depends on how current and future costs compare with existing average costs. If marginal cost is rising – perhaps because of increasing traffic volumes, scarcity of suitable land, rising congestion and increasingly onerous planning restrictions – large economic rents may be earned from existing roads. Conversely, in an economic downturn lower freight and traffic volumes may force prices to track short-run marginal cost for a prolonged period. Economic losses could be expected and, as the French experience demonstrates, bankruptcy of road companies is possible.

2.5.3 As the example of Telecom illustrates, a stance which frowns on profits achieved by major reductions in costs and unit prices will surely weaken the incentive of road companies to aggressively lower costs. It is important to remember here that it may not be the road company's costs that determine the lower limit for unit prices for roads that are competing with sea, air and rail transport. The lower limit on prices may be set instead by the price/quality characteristics of the road's competitors. Inframarginal suppliers can earn economic rents without raising monopoly concerns.

2.6 Concluding comment

2.6.1 Cumulatively, the proposed constraints represent a serious potential impediment to economic efficiency. Two possible factors could be contributing to the questionable aspects of the proposed structure – concerns about monopoly and vested interests. These are discussed in the next two sections.

3 The monopoly problem

3.1 The restrictions listed in the previous section on governance arrangements, prices and revenues no doubt reflect, at least in part, concerns about the potential for monopoly pricing. We agree that monopoly concerns must be addressed, but not that the proposed measures are necessary or desirable from this perspective.

3.2 Our first point is that the scope for monopoly pricing varies markedly across the road network. Monopoly problems are not likely to be troublesome where rail, sea or air are competitive alternatives. This most obviously applies to the major state highway routes. Competition along portions of these highways would also come from independently owned local roads.

3.3 The Document explicitly acknowledges this point at the top of page 40. But it incorrectly qualifies it by immediately stating: "However, for many trips,

road users would have no realistic alternative to using the roads of a particular road provider". The qualification is incorrect because it is competition at the margin that constrains monopoly pricing. In our view, these are no major monopoly issues for long-haul road routes.

- 3.4 If this is accepted, Transit New Zealand could be set up as a for-profit state-owned enterprise, be given a commercial board, and instructed to prepare a commercial proposal for the introduction of direct billing technologies. There would be no need for the plethora of constraints on its pricing policies that was enumerated in the previous section. New Zealand would then have a basis for moving ahead with much-improved incentives and structures compared with current and proposed arrangements.
- 3.5 It is possible that some parts of the state highway network could raise significant monopoly problems because of geographic restrictions on alternative routes and the absence of inter-modal competition. Such concerns should be investigated. Options include obliging Transit New Zealand to divest those roads, tendering the franchise to maintain and expand those roads as capacity required, or obliging Transit New Zealand to commit to a fixed-price, term contract for those roads that removes uncertainty from road users for a defined period. In our view, it would be unwise for New Zealand to rely on a 'big bang' approach to the expansion of private sector competition for roads. Instead, as in the United States, opportunities should be taken as they arise to introduce greater private sector involvement on a piece-wise basis. Hence, amongst the options just discussed we would urge that serious consideration be given to those that would create greater private sector participation.
- 3.6 Second, non-through suburban or rural access roads lie at the other extreme to long-haul state highway routes. Those residing alongside any existing non-through local road can be thought of as the members of a club that owns a common driveway. These access roads are typically uncongested and require maintenance, but not material capital works. (Where new subdivisions are required, the developer funds the capital expenses of the

associated new roads from the sale of sections.) Competitive tendering of road maintenance contracts and tying price changes to those costs eliminate any problems of monopoly pricing and productive inefficiency. Those residing alongside these roads should collectively determine the level of service. It is here that the greatest efficiency gains may be achievable in respect of these roads. A degree of coercion may be necessary to overcome free-rider problems if road providers do not have the ability to deny access to those who will not pay. However, the desirability of not giving road providers the right to deny access to those who refuse to pay should not be taken as self-evident. Roth could find no cases in the United States of homeowners or businesses being denied access to their premises by street owners. He concluded that: "World-wide experience so far does not point to any adverse consequences arising out of commercial ownership of local streets".³

3.7 Third, and of greatest apparent difficulty, are the monopoly issues in respect of suburban and rural feeder roads and CBD roads. Here non-resident through traffic can materially increase maintenance costs and sea, air or rail may not provide competitive alternatives. In addition, traffic growth may create the need for additional capital expenditures from time to time and create a possible need for congestion pricing. This is where competitive entrepreneurial processes offer the scope for the greatest gains, while monopoly issues are the most serious.

3.8 Where state highways also provide access to a local CBD, competition between road providers is possible for local roads under the proposed arrangements. Other constraints on monopoly pricing arise from substitutes for road travel. These include cycling, walking, telephone lines and, in the longer run, relocation.

3.9 As discussed in section 2, the greatest potential monopoly concerns arguably arise when local authorities own the local roads. Councils have strong incentives to use their regulatory powers to restrict competition for locally

³ Roth, *op cit*, p 165.

owned roads while creating pricing structures that cross-subsidise politically powerful groups. Preventing competition is fundamental to the preservation of cross-subsidies. Dominant local authority-owned road companies would have no strong incentive to introduce new billing technologies at the optimal time in terms of road user willingness to pay.

- 3.10 As discussed in section 2, private ownership of parts of the network and competitive entry are the most promising means of addressing monopoly problems. The Document overlooks the desirability of direct competition from privately owned or controlled local roads. Greater attention also needs to be paid to the opportunities for better controlling the abuse of a dominant position by road companies owned by local authorities.

4 Concluding comments

- 4.1 In making these comments, we acknowledge that political factors in road reform are relevant. Governments and supporters of the reforms must build a constituency for change. In doing so they have to deal with ignorance, rational and irrational fears, and the opposition of those who face the certain knowledge that they must lose their special privileges if the gains from reform are to be achieved.
- 4.2 Rational argument and open debate is the best and most democratic approach. (The case for private ownership of roads should be explicitly acknowledged and debated by the government, for example.) But principled leadership and determination by the government to remove privileges is essential if debate is to focus on how best to implement desirable reforms, rather than on whether to do so. Vacillation by the government can only encourage those with privileges to redouble their efforts to stop the reform process entirely.
- 4.3 There is a danger that failure to confront directly such issues as ownership will lead the government to attempt to build a constituency for change by conceding too much to entrenched interests. Our analysis suggests that the

current reform proposals are conceding too much to the following special interests:

- local authorities;
- Transfund;
- those who benefit from uncommercial roads; and
- those who use buses and trains.

4.4 In addition, the proposals appear to put too little reliance on market solutions to monopoly problems and too much reliance on regulation and government ownership. Regulatory risks appear to be particularly high. In part this is because of the tendency to think of all parts of the system as being equally monopolistic. In our view there is a major danger of excessive regulation of state highways and of private roads.

4.5 There is also a risk that the reform package might offer too many new privileges at the expense of the common good. For example, the package may permit special interests to use safety, environmental, or planning regulations to unduly serve their own ends in ways that undermine the clarity of road operators' property rights.

4.6 While we still strongly support the thrust of the proposed reforms, in our view the current proposals put the full potential benefits too much at risk. There are many ways of proceeding at less risk. The most obvious is to move ahead with the commercialisation of Transit New Zealand while more work is done on the problem of overcoming the problems posed by local authorities, Transfund and subsidies for local buses and trains.