

Releasing the infrastructure handbrake

Address to the Melbourne Institute and the Australian
2008 Economic and Social Outlook Conference

Rod Sims
Director
Port Jackson Partners Limited

28 March 2008

Releasing the infrastructure handbrake

Welcome to what will be a fascinating year in relation to infrastructure issues. We have the potential for a significant infrastructure reform agenda, and we will experience an important interplay between greenhouse policies and infrastructure issues that I will discuss later.

The potential for a significant infrastructure reform agenda has opened up with the change of Government. Not only has the new Government made infrastructure a key policy theme, they have flagged three important changes.

The first is to reinvigorate the Council of Australian Governments (COAG) and, I strongly suspect, they will also reverse the previous Government's mistake of ceasing competition policy payments (albeit they may introduce them in a new form). These are crucial changes because infrastructure reform requires co-ordinated Commonwealth-State action, and the Commonwealth must provide incentives to get all governments moving in the same direction.

The second change is the creation of Infrastructure Australia to audit the nation's infrastructure in terms of adequacy, identify policy bottlenecks and facilitate a way forward. It has the potential to play a large role but its challenge will be to focus at least as much on removing bottlenecks as it does on project identification.

The third change is that, pre election, the ALP acknowledged a strong role for the Commonwealth Government in urban infrastructure issues, particularly urban water and transport congestion. I have long believed the Commonwealth must play a well targeted role in these issues.

While infrastructure has not generally been a popular topic, its proper functioning or otherwise can have a profound affect on our productivity and growth potential. In a direct sense, as we all know, poor infrastructure can threaten key inputs to production.

The indirect or perception effects can, however, also be important. Bob Carr once said that we may need to slow Sydney's growth to accommodate its available urban water. In general people often see poor infrastructure as a symptom of our society running into natural barriers to growth.

They should instead see poor infrastructure as an artificial handbrake on growth, and encourage their governments to release this handbrake.

So how should we release this handbrake? In my mind there are simple steps we should take in each sector to build an exciting overall reform agenda. I acknowledge, however, that while some clear thinking can identify the required steps, a lot of hard work is needed to see the required changes implemented effectively.

Freight Transport

Land transport is, I think, one of the least sexy infrastructure topics, and it has often suffered from a lack of attention by governments. While the queues of ships off our

coal ports gain the headlines we should equally focus on truck trailers parked on the side of roads outside our main cities due to a lack of intermodal facilities, inadequate general cargo port capacity, poor access to ports for heavy vehicles, inadequate roads such as the Pacific Highway and under-investment in rail lines. And all this as our freight task is growing rapidly.

At least as important are the policy challenges. For example, as the Productivity Commission said in a December 2006 report, we undercharge large trucks for the use of the road, we need to move to mass and location-based truck user charges, and there is a disconnect between road revenue and spending decisions. I suspect the undercharging is still apparent even after the recent increase in truck user charges.

As an example of the problems caused we will struggle to transport our wheat crop with good rains. Governments are reluctant to allow trucks on the roads to transport the grain as they do not pay for the damage they cause, yet low truck charges make rail freight unviable, as indicated by Pacific National's recent decision to cease its export grain haulage operations.

My hope is that over the next 12-24 months we will see Infrastructure Australia highlight the main freight bottlenecks and determine how they can be addressed. Most important, however, I hope Infrastructure Australia determines why these bottlenecks have arisen and remained for so long.

I would also like to see a broad approach taken to freight transport issues. That is, in addition to bringing integrated transport planning and funding, I hope Infrastructure Australia will focus on road and rail pricing and funding, the need for national transport regulation to create a national freight market, and an end to rules that see, for example, Port Botany unable to accept most trucks other than at times of peak road congestion.

Urban transport

A more exciting topic is urban transport because we all suffer from traffic congestion and poor public transport.

While the situation is bad now the BTRE predicts that urban traffic congestion is set to double by 2020. Imagine this: they predict that what you currently experience at peak times will become the norm throughout the day, and that peak traffic congestion will get much worse.

We need all governments to agree to pursue policies that will stop the increasing traffic congestion in our cities. All major cities have sophisticated city traffic models that can predict future congestion levels. We need policies that will see those models predict no worsening in congestion over current levels.

If we do not plan now for this outcome it will not happen.

Such planning will, I believe, see the need for integrated approaches based around three steps.

First, there will need to be serious consideration of congestion charging. We must consider rationing the use of what is a finite resource: the roads that lead into our city centres. A small number of cars off the roads at specific peak times will make a significant difference.

Second, we need to spend more on providing reliable and frequent public transport and we need to take steps to make it much more efficient. While many will not like my reference to what they will see as a congestion tax, the proceeds could be used on funding improved public transport.

Third, we will also need better integrated road networks. Some recent road construction in Sydney, for example, has simply created new choke points.

Water Issues

It has been my contention for some time that Australia does not suffer from a lack of water; rather it suffers from poor water policies that are seen in, for example, the past over allocation of the available rural water, and a lack of investment in and low prices for urban water. A lack of water will not constrain our economic growth, but poor water policies will.

Rural Water

With rural water the key concern remains the past over-allocation of both surface and groundwater systems. This reflects poor water planning, which has been made worse by inadequate metering and water accounting systems, and which has been reinforced by low rural water prices. These have encouraged waste rather than the careful management of a scarce resource.

In addition, there has been slow progress on water trading, although with the drought the level of trading has recently increased. There remain, however, many barriers to trade in the form of fixed trading limits, exit fees, a lack of agreed title documents and local catchment structures and rules.

We have seen, of course, the previous Commonwealth Government's \$10 billion rural water plan which is to spend around \$6 billion to improve water infrastructure and \$3 billion on buying back excess water entitlements. Perhaps the key change however is that, in addition to having the funds to buy back water, the Commonwealth now controls the total amount of water that can be taken by irrigators in the Murray Darling Basin.

This raises the question of how quickly can we remove the over-allocation of water from the Murray Darling Basin? The key requirements may be, first, agreement on what constitutes the sustainable yield from a basin, and so what represents over allocation; second, removing the barriers to water trading; and third, a willingness to buy back excess water entitlements.

Urban Water

While droughts never help, our current urban water problems are a reflection of a lack of investment in new water supply over the last 20-30 years as Australia's population has increased. What else did we expect to happen?

In addition, in most parts of Australia, water prices have been too low and so they have not sent the right signals for water demand and supply.

I see the need for three steps.

First, we need to ensure that, as we start to invest again in urban water, all sources of new supply are considered and transparently evaluated. As part of this consideration we should remove the barriers to water recycling and storm water capture, such as access to facilities and some regulatory issues, and overcome the irrational concerns about rural to urban water trading.

Second, we need all water prices to reflect the cost of the next source of supply, and we need to review the effects of postage stamp pricing.

Third, we need to explore the idea I raised in 2006 that large water users be able to reach agreement with any supplier to meet their needs above a minimum supply level at a regulated price that would be available to all households. The objectives are to allow large users to take responsibility for their own supply, and to introduce some market signals and so help offset the political constraints that have held back past decision making.

Electricity

Our electricity sector faces a range of longstanding issues that should be addressed, including the need for more appropriate and dynamic regional boundaries, a more national approach to transmission investment, the removal of retail price caps, the roll-out of smart meters and national non-price retail regulation.

I have spoken on all these issues previously.

Of more immediate interest is that this year will see Australia settle the details of an emissions trading regime. Despite the fact that Ross Garnaut's scheme outline is similar to previous outlines, only now are we waking up to the implications of this enormous change. Where Ross's scheme has raised controversy is in its treatment of the electricity sector and there is considerable confusion surrounding this important topic.

The key point is to distinguish the equity issues from the real economy effects.

We are all familiar with the European experience of issuing free permits to its power sector. Power prices went up anyway and the power industry made windfall gains. This understanding has long been factored into the Australian design debate and we need to move on.

There is then the equity debate. Should we provide a one-off distribution of permits or cash to at least in part compensate for the major asset write downs that coal-fired power producers and some others will face?

This will turn on whether you believe that people who invested within both the rules and the policy intent of the Government of the day should be compensated for a profound change in policy that upends the previous electricity generation cost curve. Alternatively, there is the argument that they should have heeded the science and adapted much earlier. This will be a debate played out with strong emotion on both sides. Ross has clearly signalled that he opposes compensation to those industries that will suffer disproportional loss with emissions trading and this is a departure from previous views.

What needs discussion, however, and what is a separate issue, is the question of the real economy effects. That is, how well will our power supply cope with the considerable transitional effects of the introduction of emissions trading. Let me illustrate with four examples of important issues.

First, there has been for some time, and remains, an impossible environment for the new electricity generation investment that is needed, other than in wind energy which essentially only generates electricity when the wind blows.

Second, the government has mandated that 20% of our energy will come from renewable sources by 2020. This policy contradicts emissions trading and will see two prices on carbon for Australia's energy sector.

Third, the likely new wind energy that the investment uncertainty and the renewable scheme will drive will be located further away from existing transmission lines. They will not only require expensive transmission connection, with higher loss factors, but they will require other transmission support investment to allow the energy supply to be balanced real time across the system.

Currently these connection and "deeper" transmission costs are borne by the new supplier. Ross Garnaut has recently flagged that such costs could be funded by taxpayers. We need to be very careful, however, that we are not subsidising generation into the system that would not be economic once we know future greenhouse emission prices.

The fourth issue is the effects on our power supply, particularly in periods of rapidly rising peak demand, of a high emission permit price causing gas-fired electricity generation to become base load and some coal-fired generators to move to intermediate supply.

The key point from all of the above is that those designing the emissions trading scheme will have to factor in detailed scenarios of what its introduction can do to the electricity market. We need to focus on the real economy effects rather than only on the equity issues.

* * *

These are fascinating times for those of us who are interested in infrastructure. There is an exciting reform agenda available for governments to adopt if they want to, and the greenhouse policies will need careful crafting.

28 March 2008

Examples of previous papers on infrastructure and greenhouse issues by Rod Sims

Six key infrastructure reform questions; and are we underestimating the challenge of meeting greenhouse targets?

Address to the “New Directions in Economic Policy” forum held by the Economic Society of Australia, February 2008

Revitalising Infrastructure Reform – September 2007, for the BCA

Establishing credible targets for greenhouse gas reduction
Report for the BCA in May 2007

Determining the appropriate policy principles to guide the response to the greenhouse challenge

Report for the BCA in April 2007

Water under pressure The need for water infrastructure reform, and the main steps that should now be taken

Report for the BCA in October 2006

Reforming and Restoring Australia’s infrastructure

Report for the BCA in March 2005

Practical steps to address the key problem facing the NEM:

Five markets, not one

Address to ACCC Annual Regulatory Conference, August 2003

Creating Value from Energy Networks, 6th International Transmission and Distribution Conference and Exhibition, November 2001

Changing the Signals to put Railways on Track, CEDA publications titled “Implementing the Hilmer Competition Reforms”, November 1996