Productivity Commission Submission to the NCC's Review of the WA Rail Access Regime

Introduction

The Commission has recently undertaken an inquiry into *Progress in Rail Reform*. The final report was submitted to the Commonwealth Government in August 1999, but has yet to be publicly released. Comments in this submission are based on the Commission's Draft Report which is publicly available (PC 1999a). Issues relating to railways also have arisen in other Commission work, notably the Commission's inquiries into *The Australian Black Coal Industry* (PC 1998) and the *Impact of Competition Policy Reforms on Rural and Regional Australia* (PC 1999b).

The Commission notes the NCC's request that submissions focus on matters *not* canvassed in the initial public consultation process, including proposed amendments to the regime. In this submission, the Commission focuses its comments on two issues relating to the proposed amendments to the regime: the allocation of train paths (including capacity transfer arrangements); and asset valuation.

Capacity trading

Competition between train operators for schedules is an important element of competition in the rail industry.

The allocation and reallocation of train schedules is a vexed issue. Any allocation system must balance the rights of existing operators with the need to introduce flexibility, facilitate new entry and ensure the most efficient use of track infrastructure. The Commission has argued that:

> The availability, price and allocation of suitable train schedules is an important factor that can influence the ability of operators to enter the market and run viable train services. (PC 1999a, p. 152)

FreightCorp, in its initial submission to the NCC, noted that the issue of path allocation has not been adequately dealt with in any of the jurisdictions within which it operates. It stated that:

> The general solution has tended to be to allow existing users to retain their allocations, with additional paths fitted around these. (FreightCorp Submission, p. 11)

FreightCorp argued further that:

> While the current solution of grandfathering rights may preserve the rights of incumbents, it fails to address two crucial areas:
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> - It favors incumbents over new entrants, and depending on the precise circumstances, can be a very severe deterrent to competition. As this is the whole reason for setting up open access to infrastructure, it makes the whole model redundant.
> - It mitigates against efficient use of the infrastructure. As infrastructure owners are unable to amend the paths provided to existing users, new paths have to be weaved around these. … Often, significant improvements could be made to large parts of the timetable if some of the incumbent paths could be adjusted. In former times where all the trains belonged to one operator, this could be done by internal management. However, there is no imperative (and sometimes no benefit) to an incumbent to modify a path which caused distortion under the new model. (FreightCorp Submission, p. 12)

Capacity trading arrangements have the potential to ‘free up’ the allocation of train paths and ensure that schedules are obtained by those operators who value them most highly. These arrangements have the potential to benefit both existing operators and new entrants. The Commission supports the inclusion of a capacity trading policy in the regime.

However, the nature of the capacity trading mechanism implemented in Western Australia will affect its effectiveness in freeing up the allocation of paths and fostering competition.

Capacity trading policies can be administrative or market based. Either mechanism can introduce flexibility in the process for allocating and reallocating schedules among both existing operators and new entrants. However, the merits of each approach should be assessed prior to drawing implications for the Western Australian rail access regime.

Administrative mechanisms

Administrative capacity transfer mechanisms provide the opportunity for the transfer of schedules between operators. Unused schedules are not traded between operators but are reallocated by the central agency providing access. Existing holders of train schedules can voluntarily relinquish their entitlements to the central agency, which then makes them available to other existing operators or new entrants.

In addition, administrative capacity transfer arrangements could contain ‘use it or lose it’ provisions. An existing operator could be required to relinquish schedules if they are not used within a reasonable time. The central agency would then be free to reallocate these schedules to other operators. ‘Use it or lose it’ provisions have the advantage of limiting the ability of incumbents to restrict entry and competition by hoarding train schedules.

Administrative arrangements offer some flexibility in schedule allocation and make unused schedules available to incumbent or new operators. However, they suffer from several weaknesses stemming from the lack of market (price) signals for train schedules.

The allocation of schedules under administrative arrangements is unlikely to reflect the value an operator places on using the track at the time allocated in the schedule. Incumbents are likely to retain their existing schedules, regardless of the value they place on that particular time. In the absence of a formal market they may be unaware of the value placed on that schedule by other operators.

New schedules must be negotiated to fit in with those already held by incumbent operators. This may require protracted negotiations between operators. The likelihood of a quick resolution to such negotiations is diminished because there may be little, or no, incentive for incumbent operators to change their schedules. Moreover, they face financial disincentives in changing their schedules due to the costs incurred in changing timetables and informing customers of the change in operating times.

In the case of a vertically integrated railway, potential conflicts of interest may undermine confidence in the fairness of the capacity trading arrangements. Operators may be distrustful of an administrative transfer system controlled by an agency which may also be an actual or potential competitor.

The Rail Access Corporation (RAC 1999) has released, for public comment, a draft capacity transfer policy to apply in New South Wales. The draft policy appears to be based largely on administrative processes. It provides for the RAC to facilitate the transfer of access rights between operators and includes ‘use it or lose it’ provisions. However, it is unclear whether, under the proposed arrangements, the transfer of access rights between operators would involve payment.

Market-based mechanisms

Market-based capacity transfer mechanisms permit the trading of schedules among operators in return for payment. The central agency administering access remains responsible for setting the initial terms and conditions of access and ensuring that these are met. However, operators are free to deal directly with each other and negotiate the trade of schedules in return for a market determined payment.

Compared with administrative arrangements, market-based mechanisms ensure a more economically efficient allocation of train schedules among operators. The trading of schedules among operators provides the opportunity for those who value access most highly to acquire the schedules they require.

Market-based mechanisms can also include 'use it or lose it' provisions to prevent attempts to monopolise ownership of schedules. These provisions are unlikely to be as onerous as under an administrative mechanism because of the differing incentives faced by schedule owners in a market environment.

A market for schedules ensures that there is an incentive for operators to continually re-evaluate their access requirements and timetables in order to ensure that they are maximising profits based on available trading opportunities. That is, market-based systems generate an opportunity cost of holding schedules determined by the value of the schedule on the open market. There is thus a disincentive for existing operators to hoard schedules to forestall entry. If the existing owner does not value the schedule particularly highly, it will make commercial sense to sell the schedule to another operator (possibly a new entrant) who values it more.

The market value of schedules will in turn provide the track owner with information on the demand for track infrastructure and therefore generate useful data on which to base future investment and maintenance decisions.

An operator who is not currently using a particular schedule may be permitted to lease it to another operator for an agreed period and price. This permits the existing schedule holder to retain ownership, even if that operator does not wish to use it in the short term.

The Commission accordingly supports the introduction of market-based capacity trading arrangements. This view is consistent with the Commission's Draft Report on *Progress in Rail Reform*, where it was recommended that:

> The pricing and allocation of train schedules should reflect the value that users place on the track. (PC 1999a, p. 155)

Implications for the WA Rail Access Regime

In the Commission's view, the Western Australian rail access regime should include provision for a flexible, market-based, capacity transfer and trading mechanism. Following discussions with the NCC, the Western Australian government has proposed that Section 44(2) of the Government Railways (Access) Code 1999 be amended to read:

> As soon as is practicable after the commencement of this Code, the Commission is to prepare and submit to the Regulator a statement of the policy that it will apply ("a statement of policy") in —
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> (a) the allocation of train paths; and
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> (b) the provision of access to train paths that have ceased to be used.

The NCC has indicated its preliminary view that these amendments are an appropriate response to the market's concerns (NCC 1999, p. 57).

The Commission has several concerns with the proposed amendments to the Code. In particular, there is no explicit requirement to develop a general capacity transfer policy. To the extent that Section 44(2)(a) might be thought not to prevent such a transfer policy, it seems to be interpreted as relating to the initial allocation of schedules. Section 44(2)(b) only requires the development of a policy for providing access to paths which have ceased to be used. That is, only excess capacity is being reallocated. It does not imply that there will be competition for existing schedules which are currently being used.

The Commission suggests that an explicit requirement to develop a capacity transfer policy be included in the Code. Furthermore, in light of the discussion in preceding sections, it should require the development of a market-based mechanism. The Commission suggests that Section 44(2)(b) be redrafted to read:

> (b) the market-based transfer of capacity among operators.

Asset valuation

There is no simple answer to the complex issue of appropriate asset valuation methodologies. The method of valuing assets in railways differs across jurisdictions and includes historical costs, replacement costs and deprival methods (PC 1999a, p. 156). This is perhaps not surprising given that it is often argued that the choice of asset valuation should be made on a case by case basis, depending upon the objectives for which the asset valuations are sought (CCNCO 1998).

There are advantages and disadvantages associated with each valuation methodology. Historical costs have the advantage of being transparent and easy to administer. However, that approach takes no account of over investment and ‘gold plating’ of the infrastructure and faces difficulties in periods of inflation and technological change. Replacement costs and deprival valuations may better capture the value of economic services provided by the assets. However, these approaches can face significant implementation problems — especially if the approach requires the identification of an ‘optimum’ asset configuration.

An overview of the advantages and disadvantages of various methodologies is provided in the Steering Committee on National Performance Monitoring of Government Trading Enterprises (1994). Easton (1996) also provides a detailed analysis of different methodologies applied specifically to railways. In addition, the Commission received a range of submissions commenting on asset valuation issues in its recent inquiry into *Progress in Rail Reform*. A list of key submissions is included in Attachment A.

The Western Australian government proposes to value assets based on their Gross Replacement Value (GRV). The Commission has not undertaken a detailed analysis of the advantages or disadvantages of this methodology. It notes, however, that the Independent Pricing and Regulatory Tribunal of New South Wales (IPART) conducted a detailed review of aspects of the New South Wales Rail Access Regime, including the appropriate asset valuation methodology to be applied. IPART (1999) recommended the adoption of a Depreciated Optimised Replacement Cost (DORC) methodology.

The Commission is concerned at the multiplicity of methodologies being adopted across Australia for essentially the same task — the valuation of railway assets. These valuations are used in the calculation of rates of return and the specification of floor and ceiling prices for access. The similarity in purpose for which the asset valuations are sought suggests a need for similar methodologies across jurisdictions. (There is a particular concern that the choice of methodology could, in some cases, be made such as to justify higher revenue streams, thus potentially increasing the sale proceeds to government were the railway to be privatised).

The NCC should examine the relative merits of the differing approaches to valuing railway assets and encourage an approach in Western Australia that will facilitate greater consistency among jurisdictions.

Attachment A

This attachment lists those key submissions received during the Commission’s recent inquiry into *Progress in Rail Reform* which commented on appropriate asset valuation methodologies.

Participant	*Submission No.*
Easton, Dr E	50, 94
NSW Minerals Council	39, 104
Queensland Mining Council	77
Shell Coal Pty Ltd	36
Westrail	107

The submissions are available on the Productivity Commission’s website at: www.pc.gov.au/inquiry/rail/subs/sublist.html

References

CCNCO (Commonwealth Competitive Neutrality Complaints Office) 1998, *Cost Allocation and Pricing*, CCNCO Research Paper, Productivity Commission, Canberra, October.

Easton, E.W. 1996, *Rail Charges and Costs: Transport of Export Coal*, PhD thesis, School of Economics, Faculty of Economics and Commerce, University of Adelaide, August.

FreightCorp 1999, *Submission to the National Competition Council in Response to the Application for Certification of a Rail Access Regime by the Western Australian Government*.

IPART (Independent Pricing and Regulatory Tribunal of New South Wales) 1999, *Aspects of the NSW Rail Access Regime*, Final Report, April.

NCC (National Competition Council) 1999, *WA Access Regime*, Draft Recommendation, September.

PC (Productivity Commission) 1998, *The Australian Black Coal Industry*, Final Report no. 1, AusInfo, Canberra.

—— 1999a, *Progress in Rail Reform*, Draft Report, AusInfo, Canberra.

—— 1999b, *Impact of Competition Policy Reforms on Rural and Regional Australia*, Final Report no. 8, AusInfo, Canberra.

RAC (Rail Access Corporation) 1999, *Draft Capacity Transfer Policy*, March, Sydney.

Steering Committee on National Performance Monitoring of Government Trading Enterprises 1994, *Guidelines on Accounting Policy for Valuation of Assets of Government Trading Enterprises*, October.