

**Dr John Salerian**  
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**Progress in Rail Reform Inquiry**  
**Productivity Commission**  
**LB2 Collins Street East**  
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Dear John

**Submission to Productivity Commission Inquiry into the Progress in Rail Reform**

I am writing to enclose a copy of the Department of Industry, Science and Resources Submission to the Progress in Rail Reform Inquiry for your consideration. I apologise for the delay in our submission due to machinery of Government nment changes.

Thank you for providing the Department with an opportunity to comment.

Yours sincerely

Tim Mackey  
Deputy CEO  
Resources and Energy

December 1998

Submission to the Productivity Commission Inquiry

into

Progress in Rail Reform

Commonwealth Department of Industry, Science and Resources

December 1998



## Executive Summary

The 1990s have seen a number of changes to Australia's rail system. Reforms have included those introduced under National Competition Policy (NCP) and privatisation of former Commonwealth and State assets.

The NCP reforms including access and structural separation have had some impact on the cost of rail freight and on improving the quality of service. However, although sound in principle, the process of determining access arrangements has been time-consuming and expensive. In future more attention needs to be given to achieving the best possible outcome at the lowest cost.

We support the NCP process of structural separation of contestable from natural monopoly elements of rail service provision, and believe the establishment in New South Wales of four separate entities each with clearly defined responsibilities is a good example of how this can be done. These reforms have been accompanied by significant reductions in coal rail freight costs averaging around \$2 per tonne. Where there is not structural separation, there is a greater need for a transparent and contestable decision making process in negotiating fair and reasonable service charges and access fees.

In Queensland, although access has not yet been formally established, we are pleased to note that the prospect of access has been a factor contributing to reduced prices for rail freight in Queensland. This has in turn improved the competitiveness of the export coal industry, one of the portfolio's largest industries.

Governments need not own rail assets. The focus of the public sector should be more on policy and regulatory issues rather than ownership and management of rail assets. However, we recognise that the community benefits of viable rail services may often outweigh commercial benefits, leading to sub-optimal investment levels if there is sole reliance on private ownership. In such cases government may have a role in identifying and financing community service obligations. Where rail infrastructure projects are commercially viable, rather than direct public sector investment, an appropriate role for Government may be to facilitate projects, eg as the Queensland Government is doing with the proposed development of rail infrastructure for the Surat-Dawson region.

The most pressing issues in rail transport today for portfolio industries are:

- (i) getting the access regimes right so that they generate genuine competition between providers of above track services;
- (ii) and the cost and efficiency of rail transport.

The portfolio believes that, in general, continuation of a balanced rail reform program will deliver significant national benefits in terms of trade and employment, benefits to industry and the general community. The submission recognises there is a need to reduce rail freight service fees in order to improve international competitiveness, especially in the resources sector. However, the submission does not attempt to specify appropriate pricing levels, but rather focuses on mechanisms for improving efficiency of rail infrastructure services and mechanisms for generating fair and reasonable prices where there are natural monopolies.

Primacy is given to reducing barriers to greater competition in the delivery of rail services and the acceptance of market outcomes in generating fair and reasonable prices.

It is recognised that the market mechanism will not always operate effectively within the provision and pricing of rail services. Given these imperfections, there is an ongoing need to monitor and benchmark the delivery of rail infrastructure services. The Bureau of Industry Economics previously undertook work of this nature. The Department is looking to the Productivity Commission to fill this gap.

## Introduction

The majority of the material in this submission is the work of the former Commonwealth Department of Primary Industries and Energy (DPE). On 21 October 1998 the Government put in place changes which transferred responsibility for resources and energy to the new Department of Industry, Science and Resources (ISR), with many of the other functions of the former DPE transferred to the new Department of Agriculture, Fishing and Forestry. The main focus of this submission is therefore on the resources and energy sector of the ISR portfolio.

There are significant unresolved issues in rail reform, which affect the competitiveness of portfolio industries. In this submission, the portfolio aims to draw attention to the:

- (i) importance of getting the access regimes right so that they generate genuine competition between providers of above track services; and
- (ii) cost and efficiency of rail transport.

## Rail Reforms in the 1990s and Issues Affecting Portfolio Industries

Bulk commodities produced by Australia's resources and energy industries are the most important freight traffic for our railways. Of the major commodities, coal and minerals account for 90 per cent of all rail freight carried in bulk. All of Queensland's **coal exports** (79 Mt in 1996-97), and most of New South Wales' (67 Mt 1996-97), are transported to port by rail. Accordingly, any excessive charging or inefficiency significantly disadvantages the Australian coal industry in the competition for export markets. The Taylor Report<sup>1</sup>, found that the evidence of inefficiencies and charging above normal commercial rates suggested that both States were falling below world performance benchmarks and collecting what was, in effect, a resource rent through their freight charges.

All of Western Australia's shipments of iron ore (135.1 Mt in 1996) were freighted by rail from mines to ports for export or domestic use. Most of the iron ore rail is privately owned and operated by mining companies. Minerals such as alumina in Western Australia and lead, zinc and copper from Mt Isa are also moved by rail to ports. Rail is also often used to transport energy and resource commodities to facilities for further processing, or to distribute to domestic markets, eg petroleum.

The Commonwealth Government's microeconomic reform agenda has consistently addressed rail issues during the 1990s. Reports have been published by the Bureau of Industry Economics (BIE 1992, 1993, and 1995a), the Industry Commission (IC 1991, 1998) and the Bureau of Transport and Communications Economics (BTCE 1992).

Consultants, Travers Morgan, carried out an analysis for the BIE (1992)<sup>2</sup> of the rail freight operating costs of Australian rail systems and world's best practice. The analysis found

<sup>1</sup>Taylor, RM ( 1996) *A report to the Australian Coal Industry Council: Study of the Australian Black Coal Industry (Queensland and New South Wales)* Canberra.

<sup>2</sup>BIE (Bureau of Industry Economics), 1992, *International Performance Indicators, Rail Freight*, Research Report 4I, AGPS, Canberra

that Australian rail systems were inferior to world's best practice in their performance on the basis of price, service, quality, operating efficiency and cost performance. The Bureau concluded that this poor relative performance impacted directly on the competitiveness of Australian firms using rail freight services.

In the absence of publishable data from rail authorities, the Industry Commission (IC) Report (1991)<sup>3</sup> drew estimates of excess charges for coal rail freights from a number of studies which had attempted to quantify the extent of overcharging. These studies showed excesses ranging from \$3.77 - 7.50 per tonne for New South Wales and \$3.50 - \$7.28 for Queensland.

The Industry Commission in its draft report (1998, p.160)<sup>4</sup> stated that the results of the previous Joint Advisory Group (JAG)<sup>5</sup> and BIE studies indicate that provision of coal rail freight in Australia is somewhat less productive than best practice overseas railways. They suggest a need for ongoing reform but a performance gap which, while not insignificant, can be reduced substantially.

Both the IC and the Hilmer Report<sup>6</sup> stated that commercial charging could be achieved through the full commercialisation of railways by corporatisation and the introduction of competition in the provision of rail freight by the State Governments allowing third party access to the rail network. The Hilmer Report stated that the proposed regime must have the flexibility to deal with access, pricing and related issues irrespective of ownership and also provide for arbitration if parties cannot reach agreement.

The 1990s have seen a number of changes to Australia's rail system. Reforms have included those introduced under National Competition Policy (NCP) and corporatisation and privatisation of both Commonwealth and State systems.

Under the NCP, Commonwealth, State and Territory governments agreed to implement seven categories of reforms, of which four are directly or potentially relevant to rail. They are:

- establishing arrangements for **access** to nationally significant infrastructure;
- processes for restructuring public sector monopoly businesses to increase competition (ea. **structural separation** of monopoly from contestable elements);
- introducing **competitive neutrality** so that government businesses do not enjoy unfair advantages when competing with private businesses; and
- extending prices oversight to certain State and Territory government businesses.

When the national *Competition Policy Reform Act 1995* was enacted it exempted the NSW and Queensland government coal-carrying services from the reform proposals (ie. a

<sup>3</sup> BIE (Bureau of Industry Economics), 1992, *International Performance Indicators, Rail Freight*, Research Report 41, AGPS, Canberra.

<sup>4</sup> Industry Commission, 1998, *Draft Report: The Australian Black Coal Industry*, April, Canberra

<sup>5</sup> Joint Advisory Group, 1994, *Queensland Rail - World's Best Practices in Export Coal Haulage*, Mercer Management Consulting, Travers Morgan.

<sup>6</sup> Independent Committee of Inquiry ( 1993), *Report by the Independent Committee of Inquiry into National Competition Policy*, AGPS, Canberra.

reduction in any monopoly rent charged by the rail systems for coal freight) for five years (ie until 2000). The exemption did not prevent either State Government from moving to allow third party access to the rail network through declaration of an access regime by the National Competition Council.

The issues affecting our portfolio industries relate to access and the high cost to industry of negotiating access and the cost and efficiency of rail transport. The discussion below focuses on these aspects.

## **Competition and Access Regimes**

The new competitive environment, based on the reforms flowing from the Hilmer Report and set out in the NCP, presents challenges to integrated government monopolies such as rail. Under the Hilmer reforms, these bodies are to be opened to competition and be split up into their different market segments with new market entrants to have the right of access to the infrastructure components. In addition, there is to be competitive neutrality between publicly owned businesses and their private sector competitors (both actual and potential).

Major infrastructure facilities including rail networks typically have the characteristics of a natural monopoly, meaning that it would be uneconomic for more than one business to build and operate those facilities in the same area. The establishment of appropriate access regimes is important to portfolio industries because they would allow new rail service providers to use existing track network infrastructure thus introducing competition and, ideally, improving services and/or lower freight rates. This in turn could make Australian exports, like coal, freighted by rail to port more competitive.

### *Structural Separation*

Structural separation involves splitting a monopoly into smaller, separate entities. In rail this might involve separating track provision and maintenance and signalling from the operation of locomotives and wagons. The potential benefit lies within the contestable parts of the former monopoly, where the new competitive environment may result in lower prices and/or improvements in service quality. There are two potential advantages to portfolio industries from structural separation of rail systems. These are:

- clearer, more definitive charging systems - this reduces the scope for cross subsidisation between operating units, which we understand continues to occur, so the user can see what they are being charged for;
- and the introduction of competitive pressures for improved services and lower prices.

Under NCP, governments are not required to pursue structural reform, but have agreed to a set of principles to ensure that business structure issues are considered before any privatisation or introduction of competition into public monopoly markets.

## Case Study- Structural Separation

The New South Wales Government has implemented a structural separation in its State Rail Authority (SRA). On 1 July 1996, the NSW Government structurally separated the functions of the SRA into four separate entities:

- the SRA, previously responsible for almost all aspects of the State's rail infrastructure and services, became primarily a passenger railway operator, made up of City Rail, Countrylink and a passenger rolling stock maintenance group;
- the Rail Access Corporation (RAC), responsible for managing track, and providing operators with access to facilities in return for commercially negotiated access charges;
- the Freight Rail Corporation (FreightCorp), a State owned commercial freight rail operator; and
- the Railway Services Authority (RSA), a statutory authority which supplies rail infrastructure (track) and rolling stock goods and services including maintenance, construction and repairs to the railway industry in general.

The portfolio encourages structural separation and the opening of contestable services, such as freight services, to increasing competition, as a means of improving **the cost** efficiency of rail services.

Unlike the New South Wales Government, the Queensland Government has not established separate organisations for providing the 'below track' infrastructure and the 'above track' freight carrying service. This type of structure can also be effective in reducing costs and improving efficiency provided it ensures that decision-making, particularly in the area of pricing, is transparent and independent (at arms length) and accounting separation between the two elements is regulated by an independent body. This will provide users with more confidence in the decision making process and the application of non-discriminatory pricing.

### *Access Arrangements*

Effective competition requires third parties to have access to the services of certain essential facilities that cannot be duplicated economically, such as the rail track bed. Access has the potential to generate more efficient use of these facilities in two ways:

- the entry, or threat of entry, of new firms into the downstream markets (ea. freight forwarding) will encourage lower cost production of services (technical efficiency);
- in the longer term, competitive pressures should encourage innovation, resulting in lower costs and new services (dynamic efficiency); and
- provided the terms and conditions of access are appropriate, rail transport services should increase, so that all consumers who value the service more than its cost of supply will receive it (allocative efficiency).

However, it is important to recognise that access regimes can have significant drawbacks. The potential benefits of access can be offset by administrative and compliance costs (such as the cost of supplying the regulator with information), dispute resolution costs, and regulatory failure (imperfectly constructed or administered regulation, regulatory capture and regulatory instability). The challenge is to develop low cost regulatory arrangements



which are effective in meeting the ultimate objective of providing an efficient and competitive rail service.

In addition, access carries with it the risk that the facility owner and the parties successful in gaining access may engage in collusive behaviour and share monopoly profits, denying final consumers the benefits of access. However, this can be minimised with effective regulation.

Presently, businesses have three options through which they can gain access to infrastructure. They are:

- an undertaking, under which an infrastructure operator can make a voluntary undertaking to the ACCC setting out the terms and conditions on which access is offered;
- a declaration, under which a potential new entrant can apply to the NCC to have an infrastructure declared by the relevant State or Commonwealth Minister, after which a negotiation of terms and conditions takes place; and
- by way of a specific State or Territory regime.

The Commonwealth and the States are at varying stages in the implementation of access regimes. As far as we are aware there are presently applications for access to rail infrastructure in New South Wales (Sydney-Broken Hill and the Hunter Rail Line), Queensland (Brisbane-Cairns) and Western Australia (Kalgoorlie-Perth and parts of the Hamersley Iron system in the Pilbara).

Most of the work to date on access to rail has involved infrastructure in New South Wales, Queensland and Western Australia. The NSW and Queensland governments have also applied to the NCC to have access regimes declared as 'effective'.

## **Case Study- NSW Coal Rail Access Regime Process**

In New South Wales the Hunter Rail Access Task Force was formed in 1995 representing twenty-one coal producing companies that use the Hunter Railway Line to transport their export coal to Newcastle and other coal to the Eraring and other power stations south of Newcastle. The Taskforce has a full time staff member dedicated to the access issue. It has attempted unsuccessfully to negotiate competitive terms of access to the rail service with the NSW Government and the RAC since September 1995.

While the Taskforce concedes that some progress was made, such as the phasing out of monopoly pricing, it was done in such a way as to limit any benefit. For example, a price range was set as part of the process of phasing out monopoly pricing, but the industry is being charged at ceiling rates (applies also to any new mines and significant increases in capacity to established mines).

In April 1997, the Taskforce applied to the National Competition Council (NCC) for a declaration recommendation to achieve more competitive coal carriage. It sought to establish its case by submitting that:

- the NSW Rail Access Regime was incomplete and inappropriate;
- the terms and conditions of access were neither reasonable nor commercial; and
- the terms and conditions acted to discourage access and competition.

In parallel with the Taskforce application for declaration, the NSW Government submitted its rail access regime to the NCC for certification in June 1997.

In September 1997, the NCC accepted the Taskforce's application and recommended to the NSW Premier that the Hunter Valley rail line be declared for access.

In November 1997, the NSW Premier rejected the NCC recommendation. The Taskforce appealed against this decision to the ACCC. The appeal was heard in April 1998 and in June 1998 the Federal Court determined a full bench of the Federal Court would hear the case. In October 1998 that appeal succeeded. To date the Hunter Rail Access Task Force has incurred expenses of \$1.65 million in pursuit of access.

## **Case Study - Queensland Coal Rail Access Regime Process**

In 1997 the Queensland Government established the Queensland Competition Authority (QCA) to administer the access regime in Queensland. In March 1998, Queensland applied the access regime to certain rail services by regulation. The Queensland Government in June 1998 applied to the NCC to have the regime for access to certain rail services certified as "effective".

The proposed regime does not separate QR's ownership of the tracks and its freight hauling services. Queensland indicated in its application that it would be submitting a voluntary undertaking on conditions of access including details of pricing principles, the provision of information to access seekers, and safety

The process of determining access arrangements has been time-consuming and expensive. In future more attention needs to be given to achieving the best possible outcome at the lowest cost.

We are increasingly concerned about the high cost to industry of negotiating access. In the case of the Hunter Rail Access Task Force, \$1.65 million has been spent to date on consultants and lawyers to research and argue the case. This figure is in addition to the cost of companies' staff time spent working on the issue. In Western Australia, Robe River

Iron Associates is involved in a costly endeavour to secure access to lines controlled by Hamersley Iron Pty Limited. These are just two examples of the time-consuming and costly nature of the process.

## The Cost and Efficiency of Rail Services

There have been several studies in recent years examining the efficiency of Australian coal freight services (BIE 1992, 1993 and 1995a; JAG 1994) and the prices charged for them (BIE 1992, 1993 and 1995a).

In general, we consider that market forces should set prices for the contestable elements. (However, such competition will be effective only if access to the track is fair and equitable).

Given the monopolistic powers of the rail track owner, infrastructure service pricing (ie. the price for the use of the track) may have to be regulated. It is expected that, in the first instance, access prices should be set by negotiation between the infrastructure service provider and the freight service provider. In this case it is important to have regulations in place which set down guidelines and allow negotiations to take place in good faith by both parties. There need to be appropriate review mechanisms where the parties are unable to reach an agreement on access arrangements. Where a state government is the infrastructure service provider under a state-based access regime, there may need to be independent pricing arrangements.

Regulation of infrastructure service pricing needs to take account of a number of factors including transparency. Community Service Obligations (CSOs) are an important issue where these are imposed on rail operations.

### *Transparency*

The mechanism for calculation rail freight rates needs to be publicly transparent, fair and equitable. Transparency is an important factor in assisting companies to determine their cost structure and identify areas where their competitiveness can be improved. Service users can benefit from transparency that separates out the costs of supplying and operating the network. Transparency is also an aid to investors since it can provide greater certainty. A lack of transparency in pricing and price decision-making reduces user confidence in the service provider and provides the opportunity for excessive charging.

The Queensland Rail model which does not separate QR's ownership of the tracks and its freight hauling services, highlights the importance of transparent and 'arms lengths' access pricing arrangements between the different internal areas of QR. If decisions are referred to a third party for approval or certification, then that party should be independent and have no self interest.

The overall objective is to have access pricing mechanisms, in the absence of a competitive market, that generates 'fair and reasonable prices' through a transparent and openly contestable process, and which ensures competitive neutrality between the government

and private sectors. The national competition policies and associated agreements and legislation establish a framework for generating fair and reasonable access arrangements.

### **Case Study: History of Queensland Royal and Freight Rate Reforms for Coal**

The structure developed by Queensland reflects the previous dependence on its rail freight rates to collect *de facto* mineral royalties. In 1993 the Queensland Government announced significant reforms to the royalty and freight rate arrangements for coal. As part of these reforms:

- Queensland Rail (QR) became a corporatised body on 1 July 1995;
- all new contracts negotiated by QR since 1992 have been on a strictly 'commercial' basis and existing contracts will be renegotiated on that basis as they expire;
- contracts extending beyond 2000 will be given the option of renegotiating in that year;
- royalties on coal were increased to compensate State Government revenue for the reduction in rail
- freights;
- from 2 September 1993, two freight rate formulae - CPI minus 0.6 or CPI minus 0.3 - have applied to mines on existing contracts, with pre-1992 contracts already on that basis.

These reforms have recently been superseded by Queensland Rail announcing on 4 October 1998 that Queensland coal rail freight charges would be frozen for 1 year to provide relief, in an effort to cushion the effect of the Asian financial crisis.

### ***Cross Subsidies and Community Service Obligations (CSOs)***

In the past, inefficient infrastructure pricing policies have been used in order to meet broader policy or social goals. For example, many unprofitable rail services were often cross-subsidised by profitable rail freight services, such as the transportation of bulk mineral commodities. This has led to cross subsidisation between rail users, usually from bulk commodity users to passengers. This can impose unnecessary net costs on society as industries are unfairly penalised through having to pay inflated prices to subsidise these broader policy or social goals. The resulting higher rail costs adversely affect the competitiveness of firms in the affected industries and result in resource misallocation.

Where governments consider that target groups (such as the aged, the disabled or remote communities) require subsidisation for the cost of using rail transport, these costs should be separately and transparently funded from the budget of the relevant level of government. This would provide more accountability and transparency. Such CSOs should also be clearly defined in a contract between a rail transport provider and government, and identify what market segments or railway lines are to be supported and why. The government and society would be able to assess whether the benefits from any CSO justify its cost or whether social/equity objectives could be met by other means.

If the funding for CSOs does not come from the Budget, an unfair burden is placed on the rail carrier, putting it in a position of being unable to compete with any new carrier that does not have CSOs. Investment distortions associated with profit-earning sectors of business supporting loss-making sectors will be avoided if areas funded by CSOs are clearly identifiable. The portfolio supports CSOs being transparently funded from the Budget.

While the proposed Queensland access regime does not cover pricing principles in detail, the access regime document does state that industries' capacity to pay will be considered in determining the prices charged for access. This aspect, that is, capacity to pay, is one potentially of concern to the portfolio for economic efficiency reasons, as it may give rise to rent-seeking, particularly since coal and minerals rail freight accounted for over \$1 billion of total rail freight revenue for Queensland Rail in 199~97.

Such arrangements could reinforce previous practices that used rail services as a way of extracting economic rent from the coal and mineral industries. These practices led to inefficient investment decisions within Australia and may have contributed to decisions by Australian mining companies to invest offshore. There may also be a reduced incentive to service providers (because they are already receiving substantial profit margins) to improve the efficiency of services for higher paying industries.

## Conclusions

The most pressing issues in rail transport today for portfolio industries are:

- (i) getting the access regimes right so that they generate genuine competition between providers of above track services; and (ii) the cost of rail transport.

The cost of rail transport is an ongoing concern, felt most acutely in industries like the export coal industry. The process for negotiating access to nationally significant infrastructure, including rail, has been time-consuming and expensive. Although some applications for access have been resolved, those involving rail have been caught up in long negotiations over pricing principles.

We concur with the statement of the Industry Commission Report (1998, p.174)' that "it is of some concern that such a long and expensive process is needed for governments to apply adequately to their enterprises, competition policies which offer clear State and national benefits"

Rail continues to play an important part in the competitiveness of Australia's resource industries, which generate significant export income for Australia. We believe that the introduction of reforms in the management and operation of rail services will yield costs savings for portfolio industries and should be pursued.

<sup>1</sup> Industry Commission, 1998, *Draft Report: The Australian Black Coal industry*, April, Canberra.

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