

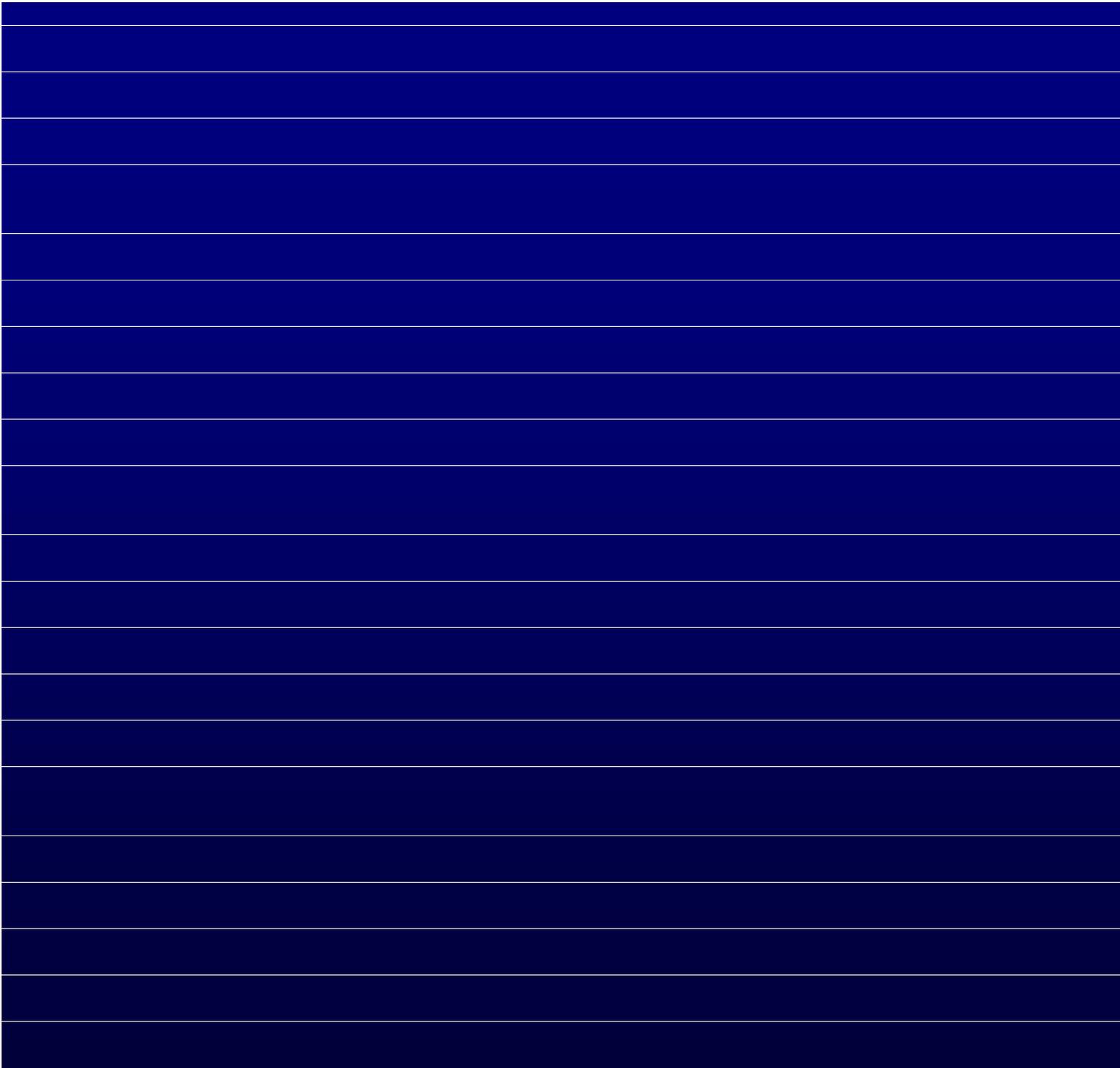


*Commonwealth
Competitive
Neutrality
Complaints Office*



National Rail Corporation Ltd

Investigation
No. 3



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The Commonwealth Competitive Neutrality Complaints Office

The Commonwealth Competitive Neutrality Complaints Office is an autonomous unit within the Productivity Commission. It was established under the *Productivity Commission Act 1998* to receive complaints, undertake complaint investigations and advise the Treasurer on the application of competitive neutrality to Commonwealth Government activities.

Information on the Office and its publications may be found on the World Wide Web at www.ccnco.gov.au.



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18 January 2000

The Honourable Joe Hockey, MP
Minister for Financial Services and Regulation
Parliament House
Canberra ACT 2600

Dear Minister

In accordance with section 21 of the *Productivity Commission Act 1998* and the Commonwealth's Competitive Neutrality Policy Statement, I have pleasure in submitting a report on our investigation regarding a competitive neutrality complaint against National Rail Corporation Ltd.

As the Commonwealth, New South Wales and Victorian Governments are co-owners of National Rail Corporation Ltd, the CCNCO has consulted with its counterpart competitive neutrality complaints offices during the course of the investigation and in the preparation of this report.

Yours sincerely

Mike Woods
Commissioner

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Abbreviations

CCNCO Commonwealth Competitive Neutrality Complaints Office

EBIT Earnings before interest and tax

NRC National Rail Corporation Ltd

Competitive neutrality policy

Competitive neutrality is a policy which aims to promote efficient competition between public and private businesses. It seeks to ensure that significant government businesses do not have net competitive advantages over their competitors simply by virtue of their government ownership. The Commonwealth, State and Territory Governments have agreed to implement this policy as part of their commitment to the National Competition Policy Reform Package.

The Commonwealth's approach is outlined in its *Competitive Neutrality Policy Statement* (CoA 1996). Competitive neutrality automatically applies to Commonwealth Government Business Enterprises, share-limited trading companies and designated Business Units. Its application to other businesses is assessed on a case-by-case basis. Further information on the application of competitive neutrality may be found in Commonwealth Treasury 1998, CCNCO 1998a, b.

The Commonwealth Government's competitive neutrality arrangements require that its designated government business activities:

- charge prices that reflect their full costs of production, including a commercial returns on capital;
- incur costs for government taxes and charges;
- pay commercial rates of interest on borrowings;
- are not advantaged or disadvantaged in performing 'non-commercial' activity at the direction of the Government;
- are not advantaged by exemption from regulations that apply to equivalent private businesses; and
- are accountable for their commercial performance.

The Commonwealth Competitive Neutrality Complaints Office is located within the Productivity Commission and is responsible for administering the Commonwealth's competitive neutrality complaints mechanism. The Office can receive complaints about Commonwealth business activities from individuals, private businesses and other interested parties.

Complaints and investigations can cover three broad areas:

- that an exposed government business is not applying competitive neutrality requirements;
- that the requirements — although complied with — are not effective; or
- that a particular government activity which has not been exposed to competitive neutrality, should be.

1 The complaint

1.1 Nature of complaint

On 6 October 1999, the Commonwealth Competitive Neutrality Complaints Office (CCNCO) received a complaint against the National Rail Corporation Ltd (NRC) lodged by Capricorn Capital Limited — a company with interests in privately-owned freight operations in competition with NRC. Capricorn Capital alleged that NRC is in breach of the competitive neutrality policies of its owner-governments because it had not earned a commercial rate of return on its assets for the financial years 1995-96, 1996-97 and 1997-98. Capricorn Capital also claimed the financial performance of NRC is worsening.

The CCNCO advised the competitive neutrality complaints offices of the New South Wales and Victorian Governments (as co-owners of NRC along with the Commonwealth Government) of the receipt of the complaint. The CCNCO consulted with those complaints offices during the course of its investigation and in the preparation of this report.

NRC provided a submission responding to Capricorn Capital's claims. The CCNCO also consulted the Commonwealth Departments of Transport and Regional Services and Finance and Administration.

1.2 Background

NRC was established in September 1991 (incorporated under Corporations Law).

Its owners are the Commonwealth, New South Wales and Victorian Governments. The equity holdings of these governments are currently around 73 per cent, 19 per cent and 8 per cent respectively. An agreement between the three shareholders and the governments of Queensland, Western Australia and South Australia provided for their respective government-owned railway authorities to transfer to NRC all of the interstate rail freight business previously conducted by them, with a view to creating an efficient commercial rail freight business.

The Shareholders Agreement establishing NRC provided for a transfer of responsibilities and assets to the corporation over a 3-year Transition Period. The Agreement also specified a 5-year Establishment Period, after which the company was expected to be fully established and to operate profitably. Both periods commenced on 1 February 1993.

As part of the transition process, the Agreement provided for (together with the transfer of those assets previously used for interstate freight) government capital injections:

- equity injections totalling \$406.5 million, completed by the end of the 1996-97 financial year; and
- restructuring injections, which were to end at the completion of the Establishment Period.

The transfer of assets and agreed responsibilities occurred significantly more slowly than envisaged in the Shareholders Agreement. Government policy changes over this period also meant that the original plan to structure NRC as a vertically integrated entity has not occurred. As a result, NRC has been established as an 'above rail' entity, required to obtain track access on commercial terms from four state government authorities. As well, NRC stated that its commercial performance has been constrained by slow progress in implementing access regimes for rail infrastructure and delays in gaining approval from State Governments for NRC to carry intrastate freight.

NRC is subject to the competitive neutrality policies of each of the three owner-governments — the Commonwealth, New South Wales and Victoria. It is specifically identified in the Commonwealth's Competitive Neutrality Policy Statement as a significant government business enterprise subject to competitive neutrality. Amongst other things, these competitive neutrality policies require NRC to earn a commercial rate of return. A commercial rate of return would normally be considered to be the long-term bond rate plus an appropriate margin for risk.

The Commonwealth and Victorian Governments announced their intention to sell their share of NRC in 1996-97. The New South Wales Government made a similar announcement in 1997-98. However, according to NRC's 1998-99 Annual Report, 'the shareholders are yet to agree ... on how the sale process is to be conducted'. In addition, following the election of a new government in Victoria in late 1999, the Victorian Government is reviewing its position on this matter.

1.3 Financial performance of NRC

The annual accounts of NRC confirm that it did not achieve a commercial return on assets in the three financial years cited by the complainant. In the subsequent and latest financial year, 1998-99, NRC recorded a negative return on assets.

NRC's financial performance has improved since its establishment; the losses recorded in 1998-99 being only a fraction of those recorded in 1990-91 (table 1). This result primarily reflects substantial reductions in expenditures, underpinned, according to NRC, by significant improvements in productivity. NRC also claims that it has made substantial improvements in a range of customer-service areas in order to win business by positioning itself as a quality supplier.

However, most of the improvement in net financial performance occurred in the initial years of NRC's operations. Since 1995-96, reductions in revenue have offset continued reductions in costs.

Table 1 National Rail financial outcomes to 1998-99 (\$ millions)

	1990-91	1995-96	1996-97	1997-98	1998-99
Operating revenue	462	476	444	438	419
Operating expenditure	783	513	490	465	437
Profit/(Loss) before tax	na ^a	2	(5)	(20)	(32)
Earnings before interest & tax (EBIT)	(321)	(37)	(45)	(27)	(18)
Abnormals	na ^a	25	44	20	1
Adjusted EBIT (excl abnormals)	na ^a	(12)	0	(7)	(17)
Shareholder equity & debt	na ^a	662	734	799	751
Return on investment (%)	na ^a	(1.8)	0	(0.9)	(2.2)

Sources: Exhibit 1 in NRC submission to the CCNCO and NRC *Annual Report 1998-99*.

Notes: (a) Not available owing to insufficient data available on the interstate freight-related assets and asset-related expenditure of the five rail authorities.

NRC has advised that its corporate plan for the period 1999-2000 to 2001-02 (the details of which are confidential), approved by its Board and agreed to by its shareholders, provides for it to achieve a positive rate of return in that 3-year period. NRC aims to achieve this primarily through continued improvements in productivity and further reductions in operating expenditure.

2 Assessment

2.1 Assessment of the complaint

As stated by the complainant, NRC has not been earning a commercial return on its assets.

However, failure to earn a commercial rate of return in any particular year, or even for several years during the establishment phase of a business, may not necessarily constitute a breach of competitive neutrality. As the CCNCO notes in its publication *Rate of Return Issues*, a business will only be undercharging if, *over a reasonable period of time*, its revenue does not cover all its costs (CCNCO 1998b, p. vii).

In assessing NRC's rate of return performance, the CCNCO has taken into account:

- the delays and variations to the scheduled transfer of responsibilities and assets during the Corporation's establishment period; and
- the scale of the operating deficit and cost structure the NRC inherited.

The CCNCO further notes that:

- NRC's corporate plan for 1999-2000 to 2000-02 foreshadows achieving a positive rate of return in this period, based mainly on continued cost reductions of a magnitude broadly consistent with those achieved in recent years; and
- in its submission, NRC stated its pricing policy for new business is to set prices to recover all costs (including capital) over time. For existing inherited business, where it appears there is no prospect of prices recovering all costs (including capital) over time, its policy is to shed that business. In principle, this approach should allow NRC to earn a commercial rate of return in the future.

That said, the rate of return target specified in NRC's corporate plan for the next three years, though positive, is below the usual indicator of a commercial return — the long-term bond rate plus a margin for risk.

2.2 Summary of findings

The CCNCO has found that:

- NRC has not earned a commercial rate of return on assets for the years 1995-96 to 1998-99, inclusive; and
- taking account of the substantial restructuring and associated delays involved in the formation of NRC, this is not sufficient to find that NRC's performance to date has been in breach of the competitive neutrality guideline which requires a government business to achieve a commercial rate of return over a reasonable period.

Given the circumstances involved in the formation of NRC, determining what is a reasonable period for NRC to achieve a commercial rate of return involves considerable judgement. Suffice to say, the level of return projected for the corporate plan to 2000-02 would not represent a commercial return if this remained the level achieved by NRC in the future and, thus, would not be sufficient to comply with competitive neutrality requirements.

If a government business is unable to operate commercially in the longer term (and thereby comply with competitive neutrality), one option is for the owner-government to sell the business. In this regard, the CCNCO notes that the Commonwealth, New South Wales and Victorian Governments have previously announced that their intention is to sell their shares in the NRC. The recently elected Victorian Government is, however, reviewing its position on this matter.

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