Legislation Review of Clause 6 of the Competition Principles Agreement and Part IIIA of the Trade Practice Act 1974

Further Submission to the Productivity Commission

Addendum

Prepared on behalf of

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by

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FREIGHT AUSTRALIA

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Introduction

This addendum is a response to the Productivity Commission's ('the Commission') request for further information and comment on the matters discussed with Freight Australia at the public hearing on May 28, 2001, *viz.*

- the Commission's proposed objective clause for Part IIIA;
- the second pricing principle proposed by the Commission;
- the cost of information disclosure; and
- the impact of access regulation on investment decisions.

Objective of Part IIIA and the 'second' pricing principle

The Commission noted that:

- in our submission of December 2000, we contended that Part IIIA should be confined to dealing with the problem of potential market foreclosure by owners of essential facilities who also operate in upstream or downstream markets.

- in our further submission of May 2001, we supported the Commission's proposal that the objective of Part IIIA should be "to promote *overall efficiency* by promoting the efficient use of, and investment in, essential infrastructure services" – even though the Commission's position is to include vertically-separated facilities under the national access regime.

The views we put forward in our first submission are consistent with those in our further submission. This is because we hinged our analysis and reasoning on a comparative institutional notion of efficiency, i.e. we consider an institutional arrangement (such as Part IIIA) to be efficient if (and only if) there are no other feasible sets of arrangements that can be implemented with net social gain.

From a comparative institutional perspective, the achievement of *overall efficiency* – as proposed by the Commission – requires that:

- facility owners can recover the full cost of providing the services so that incentives for future investment are preserved; and

- third party access regulation be applied only when the welfare gains achievable through such regulation clearly outweigh the cost of regulation and the risk of regulatory error.

As with all forms of economic regulation, Part IIIA entails positive regulatory costs. Part IIIA should focus on the problem of market foreclosure in related markets, as we believe this is the area where the regulatory costs are likely to be more than offset by the allocative *and* dynamic efficiency gains from allowing third party access. Where this is the case, Part IIIA would have achieved the goal of promoting *overall efficiency*.

We do not dispute that Part IIIA may also be used to deal with real or potential abuse of market power in a vertically-separated facility services market. However, the

regulatory costs and risks of error associated with applying the 'whole' of Part IIIA to what is essentially a monopoly pricing problem are likely to be high compared to the *static allocative efficiency gains* that can be expected from pricing regulation.

If the abuse of market power in the facility services market is indeed the problem, then we suggest that access regulation is not the most efficient mechanism for dealing with it. From a comparative institutional standpoint, there are more efficient mechanisms in other parts of the *Trade Practices Act* (e.g., s.46). Price surveillance may also be used as a measure to address serious concerns about monopoly pricing.

Consistent with this reasoning, we have suggested that the Commission's second pricing principle (*viz.* access price should not be set so far above cost) be deleted. In its current form, we believe that the principle is too vague to be of any practical use. On other hand, making it precise would risk the introduction and application of inappropriate cost-based pricing rules with intensive informational requirements. This would, in turn, create more scope for regulatory errors and higher regulatory costs.

Cost of information disclosure

At the hearing on Monday 28 May, Freight Australia was asked to quantify the cost of providing the information the Office of the Regulator General,(ORG), may request under the proposed Victorian rail access regime.

Freight Australia's representative submitted that there would probably be a one-off cost of approximately $150,000 to set up the necessary accounting and recording systems, and that ongoing system maintenance costs would be in the order of $50,000 per year. Freight Australia sought leave to examine the question in more detail and respond separately to the Commission. Below is a more considered response to the question.

The rail network Freight Australia leases from the Victorian Government consists of over 4,000 km of track, which for accounting purposes is divided into around 70 line segments. These line segments have to be classified into "freight only", "passenger only", or "freight and passenger". Where there is mixed traffic on a line segment, ie. freight and passenger systems have to be established to determine the most appropriate allocation of costs between the two types of traffic.

Expenses are incurred through five contracted maintenance and supply sources, plus Freight Australia's own internal costs.

Systems have been established to provide accounting records for Freight Australia's management purposes, and to meet statutory reporting obligations.

The ORG, however has a requirement to be advised of *future efficient costs,* (and any other information it may require in the future, as quoted at the hearing). Should new systems have to be developed, or existing systems modified substantially, the estimate provided at the hearing of at least $150,000 would seem reasonable. Ongoing maintenance costs of $70,000 to $100,000 per year would certainly be possible. Although these may seem low numbers in the overall scheme of things, they represent an increase of 5% on current accounting/IT expenses.

Impact on investment decisions

At the hearing the Freight Australia representative was questioned on the impact of the current regulatory regime on investment decisions. In response, the Commission was advised that Freight Australia's owners had resolved to suspend any discretionary investment in the rail infrastructure. This did not apply to investment required for Freight Australia to meet its contractual requirements with passenger operators on the network.

The access regime and pricing principles proposed for Victoria's freight rail network have three serious deficiencies, as far as Freight Australia and its American owners are concerned.

The first is that Freight Australia's initial investment of $90 million in pre-payments of the 45 year lease of the network is not recoverable through access charges.

The second is that the rate of return on new investment is the long term bond rate plus a margin of 4%, (a higher rate may be allowable at the discretion of the ORG, but not guaranteed).

The third is that the allowable margin on operating and maintenance costs is 10%. This has to cover overheads as well as making a contribution to profit.

Under these circumstances there is no incentive to invest in Victoria and Freight Australia is looking at deploying its resources into NSW, where it already has minor operations under a favourable access regime, and into South Australia, where the Minister for Transport has announced an access holiday for operators prepared to invest in upgrading the freight rail network.