Assessing the State of National Competition Policy for Rail

A presentation by Ed Willett
Executive Director, National Competition Council
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Introduction

Today I am going to talk about the role and effect of National Competition Policy (**NCP**) in the rail industry. It will help to start with an understanding of the broad objectives of National Competition Policy.

National Competition Policy is about creating national markets, about increasing efficiency through the liberalisation of those markets, and about effective regulation of markets where competition is not feasible or is problematic.

Infrastructure reform has a special place in National Competition Policy. As a consequence, Australia is moving rapidly and inexorably toward a National Electricity Market for most of Australia, a national market for gas supply, uniform national regulation of road transport and wholesale national reform of the water industry.

In many respects, rail transport is the poor cousin of infrastructure reform under National Competition Policy: neither totally untouched but not subject to a comprehensive reform program.

Today, I will outline what NCP has and has not done for rail reform in Australia. I will also address the things that NCP will and will not be able to do in the future. Most of all, I will discuss what the NCC is seeking to achieve by the use of its limited roles in the rail reform process.

But first, a little historical context: because the things that are happening today in the rail industry are strongly influenced by the way things have developed in the past.

Rail Before NCP

The Australian rail industry has evolved in an uncoordinated and fragmented manner, reacting to state priorities, rather than national objectives such as a compatible approach to technology investment and safety management[1].

The history of rail in Australia has been characterised by state-based development. Early rail lines were built to provide intrastate access between state capitals and regional centres with little attention paid to interstate travel or uniform operations. It was not until 1995 that the five mainland state capitals were all linked with a uniform gauge track. By this stage, despite years of restrictions and regulations on other modes of transport – such as requiring some bulk commodities to be carried by rail if at all possible – rail was rapidly declining in importance in Australian transport.

Rail reform in the early 1990s recognised the failure of rail to achieve its full potential and sought to address the industry's poor performance.

These reforms varied between jurisdictions. However, a common theme was encouraging private participation, particularly in the provision of above rail services. In addition, moves were made to address problems caused by multiple operating and safety systems and the pricing of coal freight.

Competition Policy and Rail Reform

National Competition Policy, underpinned by a series of COAG agreements and attendant changes to the Trade Practices Act, was introduced in 1995. While NCP encapsulated and developed pre-existing agreements for comprehensive reform programs in targeted industries such as gas, electricity and road transport, there was no specific reform program for the rail industry. Hence, reform obligations in rail fell to the general provisions of NCP, with the industry focussing on the general access provisions, included in Part IIIA of the TPA, to stimulate reform.

The changes to the Trade Practices Act to accommodate National Competition Policy included provision for access regulation in one of three ways – declaration, undertaking or certification.

An infrastructure owner or operator can give a written *undertaking* to the ACCC which sets out the terms and conditions on which users will be provided with access to its services.

A user can seek to have an infrastructure service *declared*, which would require the service provider to negotiate with the user for access.

An access regime, which is deemed effective, cannot be declared under the NCP arrangements. Whether a particular regime is effective can be pre-determined through a *certification* process. The certification process is available only to State and Territory access

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[1] Rail Projects Taskforce 1999, *Revitalising Rail The Private Sector Solution*, (Smorgon Report), Department of Transport and Regional Services, Canberra, Chapter 1 – Barrier 1: The lack of an Integrated National Transport Strategy.

regimes – there is no equivalent provision available for the Commonwealth and private access regimes.

To date, Part IIIA has been the focus of the rail industry more than any other industry. Declaration applications have been made both in relation to intra and interstate track services. The intrastate applications carry with them a comparable level of complexity to applications in other industries. But interstate track access carries with it a dimension all of its own and it is in this area, and particularly in the inter-relationship between inter and intrastate relationships, that the greatest challenges are now being faced.

Part IIIA is structured in such a way as to equate the provision of a service with the ownership and operation of the facility by which that service is provided. It therefore carries with it an implicit assumption of one service being provided by one facility with one infrastructure owner. To try and expand the scope of those definitions is not easy, even using lawyers' rules like the singular including the plural. This has meant that declaration of track that crosses state boundaries would seem to require as many processes as the number of track owners involved. It would also require that each state agree to declare its own infrastructure. Failing such agreement, it would require a positive review outcome from the Australian Competition Tribunal on each declaration.

Notwithstanding the complexities of interstate access, it has proven a key area for new entrants. Many of these new operators have highlighted to the Council the need for less circuitous national reform in submissions in the Council's consideration of rail service declaration applications and in certification applications.

One of the key issues raised has been the costs of meeting differing safety requirements and operating standards and access conditions across states. For instance, operators argued that while a national agreement on safety arrangements was in place, it was not fully effective because the states imposed significant additional requirements. To conform to these requirements rail operators had to develop separate applications covering the differing technologies and practices used in each state.

Further evidence regarding the fragmentation of the rail industry was also highlighted in the many submissions to the recent government inquiries relating to rail reform. The House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform (HORSCCTMR) reported in 1998 on the role of rail in the national transport network[2]. The Rail Project Taskforce (Smorgon taskforce) investigated the role of government in facilitating rail investments.[3] The draft report of the PC inquiry into progress in rail reform summarises the reform process so far, including other reviews, which have reported.[4]

Despite all these difficulties, reform in the rail industry in Australia during the 90s has been dramatic. When we face the sort of day to day issues outlined above, we sometimes have to be reminded, as Dr Philip Laird did yesterday, of how quickly things are changing for the better.

Part IIIA has played its role in this: with the declaration process driving progress in the development of state-based access arrangements and highlighting the special needs of

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2 HORSCCTMR 1998 *Tracking Australia, an Inquiry into the Role of Rail in the National Transport Network*, (Neville report).

3 Op cit n1.

4 PC 1999b, *Progress in Rail Reform*, Draft Report. Ausinfo, Canberra.

interstate arrangements. The changes we have seen in the Hunter Valley are a prominent example of the reforms being driven by Part IIIA.

One of the criticisms that is frequently made of Part IIIA is the length of time which declaration processes take. I recognise that timing is an issue in these processes, but there must always be a balance between a party's right to have a Ministerial decision reviewed and achieving speedy outcomes. In Part IIIA the balance has been struck by allowing reviews of Ministerial decisions. In some areas of telecommunications, no review rights are available from ACCC determinations. Review rights are important at least in a generic access regime. From time to time specific industries may have special needs for more speedy resolution; those should be dealt with as special cases.

The National Rail Reform Agreement

Meeting in September 1997, State and Commonwealth Transport Ministers concluded that:

> *Our interstate rail system has been managed as a discrete set of State based rail systems. This is no longer acceptable. We need a vigorous interstate rail system that supports port competition and is genuinely competitive with road transport and domestic shipping industries.*[5]

At this meeting, the Transport Ministers agreed to a series of reforms to apply to track that joined the State capitals and their ports, with connecting lines to the major regional ports of Whyalla, Port Kembla, Newcastle and Westernport. These reforms aimed to reduce the costs of transporting freight by rail by increasing train speeds and tonnages, as well as standardising practices, technologies, and access conditions.

The Ministers also agreed to establish the Australian Rail Track Corporation (**ARTC**) to provide a "one stop shop" for national rail operators. For their part, the States agreed to enter into negotiations with the corporation to achieve arrangements over State track that would allow the corporation to operate as a "one stop shop" over a national network.

While leasing of the interstate lines was the preferred approach, this has not proved possible for the entire track. ARTC owns the interstate track in South Australia and has a long term lease over the interstate track in Victoria. It has also entered into wholesaling agreements with three states - NSW, WA and Queensland.

The ARTC has begun consultations with the industry prior to lodging an undertaking with the ACCC later this year.

With these changes to the national rail reform agenda and increasing private sector involvement in the rail industry, there has been a shift in emphasis towards a more commercial approach to the operation of below track businesses.

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[5] Australian Transport Council, National Rail Communique, 10 September 1997.

Overall, the goals of rail reform can be summarised as:

- enabling the industry to provide effective competition to road freight;
- improving operating efficiency – by promoting competition above rail; and
- reducing complexity associated with national rail movements by improving the consistency of access and other regulation.

NCP issues in national rail reform

One of the main issues the Council deals with in implementing NCP for rail is the question of the interface between access regimes. These were the principal issues discussed at the 6 December 1999 National Competition Council workshop on the relationship between interstate rail services and State and Territory Access Regimes. Most of the NCP issues identified above fall into this category.

I would like now to concentrate on five separate, but interrelated issues that arise in this respect. I want to discuss each separately because often the contribution of each to overall interface issues is confused. The five areas are:

- track ownership;
- operating standards;
- safety requirements;
- funding of rail infrastructure;
- access regulation.

Track Ownership

The link between different track ownership and operation throughout Australia and difficulties in running interstate operations is obvious. With different owners of the rail infrastructure, interstate train movements will by their nature mean negotiation with each owner.

In addition, different ownership and operation of the track is the prime reason for differences in operating standards and safety requirements.

I see different track ownership and operation as the prime driver of problems associated with interstate operations, and the main problem that the ARTC is seeking to overcome. Even when the ARTC undertaking is operational there may still be issues with the interface between local, regional or state services and interstate services.

If there were one change that would most assist in the national rail reform process, it would appear to be the introduction of some form of common or joint ownership or operation of the standard gauge track in Australia.

Operating standards

Because each rail authority is separate and has grown out of a state-based system, there is a range of operating standards both within and between states. As a result of the 1997 Ministerial Agreements on Rail, there has been a more concerted effort to institute uniform operating standards. However, while operators of above rail services note that there has been progress and that the lack of uniformity alone would not impede interstate operations, it is nonetheless an added burden that say, road users do not face. Operating codes are being established to allow for greater consistency between states. However, the completion and adoption of these codes is still some way off.

Safety standards

As with operating standards, the fragmented nature of rail infrastructure ownership has lead to a lack of uniformity in safety requirements as well. Some aspects of safety have been addressed, such as mutual recognition, although some above rail operators have suggested that this has not been fully satisfactory. Overall, the process in general has been slow and in some cases fallen short of original expectations. For example, the establishment of a national safety regulator has been replaced by a means of consolidating the reporting of incidents.

Funding of Rail Infrastructure

The Council has played no role in this area at all, and after Dr Laird's presentation yesterday, what more could I say. Nonetheless, in any discussion of national rail reform, issues associated with investment (or lack of it) in below rail infrastructure need to be highlighted.

Access

In assessing State regimes for certification, the Council is required to consider national issues and determine the impact of the regime on rail services operating across State borders. However, the Council's ability to take a national view is limited by the timing of the submission of the access regimes and the nature of those regimes.

Since the 1997 inter-governmental agreement, there has been much groundwork undertaken to enable interstate rail access arrangements to be implemented, although there is still some

way to go and progress has been slow. Clearly, there are areas of overlap between interstate and intrastate regimes. In exercising its responsibility to assess State regimes, the Council places considerable weight on the principal objective of the national process – Australia-wide track access. This means that the Council's assessment of state-based access regimes will focus, among other things, on ensuring that State regimes and the national process are compatible.

The issues discussed above, combined with the Council's obligations under access and its desire to promote national rail reform has meant that it has focused on a range of factors:

- The need for good access arrangements for the substantial intrastate rail industry, while not leaving interstate services at a disadvantage and not inhibiting the future development of interstate access arrangements.

- Treatment of those parts of the interstate train paths that are covered by intrastate regimes.

- Meeting the Council's obligations under the TPA and intergovernmental agreements in a way which meshes with the national rail process.

- Responding to applications now, when there is uncertainty about when the interstate arrangements (in particular, the ACCC's consideration of the ARTC undertaking) will emerge and the detail of these arrangements.

The Council's approach to furthering the national rail reform agenda means that in the case of certification applications, it is looking to certify regimes which encompass truly national access arrangements. In the certification applications which have come to the Council to date, it is looking to ensure adherence to a number of key principles, including:

- A consistent approach to pricing, based on a pricing band between a floor and ceiling, where the floor is the incremental cost and the ceiling is the combinatorial stand alone cost;

- Independent dispute resolution processes;

- The availability of cost information to guide price negotiations;

- Regulatory guidelines on particular matters such as timepath trading.

Because of the ongoing consultation process in relation to the interstate regime, the Council is looking for flexible mechanisms which can operate immediately but which are capable of being adapted once the national processes have been finalised. To this end, the Council has generally favoured provisions for the establishment of codes of practice or conduct within the broad framework established by individual State based access regimes. These Codes to date have principally covered issues such as safety and accreditation requirements, but it seems to me that there is no reason why they could not also cover other things, such as track management arrangements and more detailed pricing principles. Providing that the regime itself provides an adequate framework and statement of the principles which are applicable, the development of Codes of this nature could be the most practical and low cost way of looking to achieve a common approach and consistency moving forward. To my mind it

would seem to be a useful goal to have stated in the regime itself that these Codes will be developed with the objective of establishing common standards with other State regimes.

Given that framework, I thought it may be useful to discuss some specific issues which the Council has considered in its certification process.

In the case of NSW, one of the Council's main concerns was the inclusion of interstate train time paths in the regime. While there were efforts made to formulate ways of dealing with allocations, these were not finalised. The Council recommended that the regime only be certified until the end of 2000, by which time, the national regime should be in place. At that time, any changes that need to be made to the NSW regime to ensure that it is compatible with the national regime, can be made.

In Western Australia, by contrast, the original access regime proposed that, as with NSW, both inter and intrastate train paths be covered by the regime. After discussion with the Council about how this could be made compatible with a national regime, the WA government revised its regime to exclude interstate train services. The Council has not yet finalised its recommendation on this regime. However, even removing the interstate services from the regime may not solve all the interface issues.

For the SA/NT application, on which the Council is also yet to make its recommendation, there is an additional issue. While the other regimes have adopted the basic floor and ceiling approach to access pricing, the governments in this instance have added a new twist to the floor and ceiling band with their Competitive Imputation Pricing Rule (CIPR). In cases where there is a competitive market, the CIPR stipules how to formulate where, within the band, access prices should fall. The CIPR states that in general the access price will be the difference between the maximum competitive price an access provider could charge for the transport of freight between two points and the above rail costs of providing the relevant freight service by the access provider. The resulting price reflects the value the operator extracts from its use of the infrastructure.

The Council, with the assistance of a rail operator, has selected a few scenarios to model likely access prices under CIPR. The results of this modeling indicate that where road is an effective competitor to rail, access prices around those currently being charged elsewhere in Australia are likely. However, the actual prices will be quite sensitive to a number of factors including the quantity of freight, the above rail technology used, the intensity with which the rolling stock is utilised, the length of trains and the degree to which freight is time sensitive.

The modeling has highlighted that the greater the volume, the more efficient the utilisation of capital and the less time sensitive the freight, the higher the access price will be.

The consideration of all three regimes has involved considerable negotiation with each jurisdiction and substantial changes to the legislation as originally proposed.

Some observations

I will now turn to some specific observations arising out of the Council's work on rail reform.

Separate Interstate Services

The 1997 national rail reform agreement focused on the creation of the ARTC to provide interstate rail services on a 'one stop shop' basis. The ARTC will prepare an access undertaking for approval by the Australian Competition and Consumer Commission on the exclusive provision of interstate services. As a consequence, state access regimes will (either implicitly or explicitly) regulate intrastate services only.

The creation of a one stop shop for interstate services is an important reform that will help overcome problems associated with multiple track owners throughout Australia. The difficulty of the task which ARTC faces, given the inconsistencies which presently exist, should not be underestimated. But resolution of these issues is critical for interstate operators.

Even with a one stop shop, interstate train operators are still concerned about potential interface problems, particularly in relation to standard gauge track that is not part of the interstate system. It may be that we need to more closely integrate interstate and intrastate arrangements to fully overcome potential interface issues. This may be achieved by, for example, ensuring that the ARTC arrangements have some standing under state access regimes and/or by ensuring that common dispute resolution processes are available for disputes involving the services of more than one railway.

'Open Access' versus 'Third-Party Access'

I'd like to comment on some things that David Marchant said yesterday, and for convenience I'll use his terminology. Broadly he compared the pros and cons of structural separation of above and below rail businesses. His analysis, I think, was consistent with the Productivity Commission's findings in its draft report on rail reform. Broadly, I agree:

- that full structural separation of the below rail business better facilitates competition in above rail operations;
- that there are some transactions costs savings (and thus efficiencies) available from vertical integration;
- that the right balance of these competing benefits will usually turn on the characteristics of demand for transport services in a particular area; and
- that this balance is most likely to favour full structural separation in the case of high volume, long distance, heterogeneous rail traffic.

I would add some points to this.

First, an open access arrangement will not of itself cure all the issues which arise from control of natural monopoly infrastructure and therefore the existence of market power in the hands of its owner. Even with a structurally separated rail operation, there will need to be appropriate regulatory mechanisms to ensure that the market power is not used to restrict output at high prices.

Second, third party access regimes for vertically integrated rail operators can provide effective rail access arrangements, but in some areas they will need to be more detailed and prescriptive to facilitate multiple train operators.

Third, as recognised by the Productivity Commission, access arrangements for low volume regional rail operations may need to be quite different from third party access regimes designed to facilitate multiple train operators. In the case of these low volume operations, the emphasis may be on contestability to ensure efficient operations by the incumbent.

Finally, structural reform is a matter of degree rather than an absolute. Separate accounting arrangements are required by the Competition Principles Agreement in clause 6(4)(n). To these obligations, the Council adds some ring-fencing obligations (particularly in relation to the treatment of confidential information) to facilitate effective negotiation of access. The National Gas Code requires a separate (but possibly related) company structure for pipeline businesses, while the COAG Electricity Agreements require full structural separation between generation, transmission and distribution businesses, although the extent of allowable shareholding by generators in transmission and especially distribution businesses is yet to be tested. Substantially lower obligations in the separation of distribution and retail electricity businesses make the picture even more complex. All this says one of two things, I think: either we rarely strike the right balance in structural reform or, more likely, the right answer is rarely easy or simple and will vary according to individual circumstances.

Structural Reform

This brings me to specific structural reform obligations under National Competition Policy in relation to rail businesses.

I've already mentioned the requirements in the Competition Principles Agreement of an effective access regime under Part IIIA of the Trade Practices Act.

Under Clause 4 of the Competition Principles Agreement, where a government is considering privatising or introducing competition to a public monopoly, the government is required to remove responsibility for regulation from the monopoly and review the structure of the monopoly, in particular to consider the separation of monopoly and competitive elements.

For example, Victoria has addressed its structural reform obligations in relation to the privatization of V-Line Freight. The above rail business has been sold with long term lease over the country rail infrastructure. The structural reform review found that the gains in terms of competition from the vertically separated track and freight business would be outweighed by the technical inefficiencies that separation would introduce. The entire country network plus the Dynon freight terminal will be subject to a third party access regime, with the Office of Regulator General as regulator.

In another example, the WA Government has proposed the privatisation of Westrail's above and below rail businesses, along with the introduction of an access regime. In response to a request from the Council the Western Australian Government has indicated that it intends to

comply fully with its structural reform obligations. The Council will consider this issue in its third tranche assessment next year.

Competitive Neutrality

The term competitive neutrality has two dimensions in relation to rail reform in Australia:

- first, the formal obligations on governments under NCP on competitive neutrality between public and private businesses;

- second, the more common reference to the question of competitive neutrality between road and rail transport operations.

Public versus Private Enterprises

In the 1995 NCP Reforms, governments committed to ensure fair competition between publicly and privately owned businesses. This involves, among other things, ensuring that public businesses reflect all of their costs in their pricing and that each government establishes a formal mechanism to address complaints about breaches of the competitive neutrality principles. To date in its assessments of governments' compliance with National Competition Policy, the Council has had cause to consider one competitive neutrality matter in relation to rail operations.

That matter involved a complaint by Coachtrans, a passenger bus operator, against Queensland Rail's passenger services pricing policy in south-east Queensland. The Council understands that Queensland will be developing a public transport framework consistent with the Queensland Competition Authority recommendations on this complaint.

Whilst the Council has addressed only one matter, unfair competitive practices by government owned railways were the subject of much comment in a recent industry survey conducted by the Department of Transport and Regional Services[6]. The complaints ranged from predatory pricing, to hoarding of rolling stock, preferential treatment for train path entitlements and conflicting roles for a portfolio Minister who bears responsibility for all aspects of transport. As far as the Council is aware, these issues have not been the subject of formal competitive neutrality complaints under the formal review mechanisms.

Whether or not the complaints being made are soundly based, from an industry perspective it is damaging if these perceptions are operating as a disincentive to investment.

Many of the complaints are not strictly competitive neutrality issues, but they highlight the need to have maximum transparency in relation to all forms of government support. Competitive neutrality issues can be further complicated by government decisions to support rail transport for particular types of traffic. It is in this area that particular care is required.

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[6] The results of this survey are analysed in the Rail Projects Taskforce Report, *Revitalising Rail: the Private Sector Solution*, April 1999 at p.14

Any preference accorded to a publicly owned train operator, including these types of community service obligation arrangements, may raise problems under the governments' competitive neutrality obligations. This does not mean that governments cannot provide rail community service obligations, merely that they may need to be carefully designed.

Road versus Rail

One of the reasons that governments may want to utilise CSOs is in order to encourage a shift of a particular type of traffic from road to rail. The reasons for this may be safety, environmental considerations or some other reason. In some cases this will be a CSO which is designed to redress the road/rail competitive neutrality imbalance. Such an approach would be consistent with the broad intent of competitive neutrality obligations, which is the elimination of resource allocation distortions which may result if, for example, external costs, in terms of the environment or safety are not addressed.

Next steps

The year ahead is likely to be very significant for rail:

- the Federal Government has foreshadowed a major policy statement;
- the Western Australian Government is moving ahead with the privatisation of Westrail's freight business;
- the sale of National Rail Corporation is still on the agenda;
- ARTC's undertaking process is moving forward; and
- increasingly, private sector operators are making inroads into the industry.

Much still remains to be done in areas such as operational and safety issues, commonality in approach to pricing and the integration of the intra and interstate regimes.

The next steps in rail reform will require detailed consultation between all sectors of the rail industry and a co-operative national approach. The last few months have shown some encouraging signs. The Council is keen to see this interaction and debate continue.