
7 Public and private participation

Although government-owned railways have improved their performance since 1991, they still lack a full commercial focus and suffer from inadequate investment. These problems stem from weaknesses in the corporatisation model. Refinements to this model may lead to some improvement in commercial focus. However, given the limitations of the model and the challenges facing the rail industry, alternatives to government provision need to be considered.

The inquiry's terms of reference require the Commission to examine the role of the Commonwealth, States and private sector in rail operations and ownership.

In this chapter, the key issues of commercial focus and investment within the rail industry are outlined (section 7.1). A number of different models of rail service provision, ranging from government department to private ownership, are examined (section 7.2). Taxation arrangements which may affect private sector involvement in railways are also discussed (section 7.3).

7.1 Objectives and the role of government

Private enterprise was responsible for the introduction of railways in Australia in the mid-nineteenth century. Governments initially became involved because private investors wanted governments to guarantee dividends and provide further capital to complete lines. When these private railway companies encountered difficulties, governments took over ownership to protect themselves from financial exposure (appendix C).

Until recently, all major state-based rail systems and interstate operations were government-owned and operated. Historically, governments used their railways to pursue objectives other than commercial viability. Goals such as income redistribution, regional development and employment creation have underpinned the provision of some train services and associated infrastructure. However, the pursuit of social or political objectives has often been at the expense of efficiency. Apart from these non-commercial objectives, governments own railways as an alternative to regulating private monopolies and as a means of addressing externalities, such as traffic congestion in urban areas.

During the 1990s, there has been a change in emphasis with governments according greater weight to improving the efficiency and financial viability of their railways. The focus on efficiency stems from the relatively poor performance of government-owned railways in the 1970s and 1980s. In its 1991 inquiry into rail transport, the Industry Commission (IC) attributed the large and persistent rail deficits during this period to government intervention in railway operations for non-economic reasons (IC 1991b).

Other factors have also had a bearing on the increasing focus of governments on the performance of their railways. Importantly, the nature of the transport market has changed considerably in the 1990s. Competitive pressures have intensified with the entry of private sector operators. Moreover, the rail industry faces significant competition from a road transport sector, characterised by a high degree of flexibility and innovation, and the potential for greater competition from sea transport.

Against this background, most government-owned railways have been commercialised or corporatised to address some of the problems identified in IC (1991b) (chapter 3). Notwithstanding these reforms, many participants in the current inquiry (including the Australian Wheat Board, Australia Southern Railroad (ASR), Forsyth and Trace, Maddock, the NSW Minerals Council and Queensland Rail (QR)) have pointed to difficulties facing railways under government ownership. Two key issues raised by participants included:

- the lack of a full commercial focus; and
- inadequate investment and maintenance funding.

Given these concerns, this chapter examines recent reforms to government-owned railways and explores different models of rail service provision. Aspects of the competitive environment are also discussed, though they are addressed more fully in chapters 6, 8 and 10.

7.2 Public/private sector models

There are a number of forms (or models) of rail service provision, ranging from government department to private enterprise provision. Under the departmental model, government is responsible for virtually all aspects of provision including planning, design, financing and funding, construction, operation, maintenance and regulation¹ (table 7.1). Under the private enterprise model, the owners or their

¹ Regulation covers economic regulation (such as price and service regulation) as well as safety and environmental regulation.

agents are involved in most aspects of provision except for regulation and the funding of community service obligations (CSOs).

Table 7.1 Main forms of rail service provision^a

<i>Areas of responsibility</i>	<i>Government department</i>	<i>Government enterprise^b</i>	<i>BOOT project</i>	<i>Franchised enterprise</i>	<i>Private enterprise</i>
Planning	G	G	G/P	G/P	G/P
Design	G	G/P	G/P	G/P	G/P
Construction	G	G/P	P	P	P
Operation	G	G/P	P	P	P
Maintenance	G	G/P	P	P	P
Ownership ^c	G	G	P → G	G/P	P
Payment for service	G/C	G/C	G/C	G/C	G/C
Regulation	G	G	G	G	G

^a G represents government, P the private sector and C consumers. ^b Traditional, commercialised or corporatised. ^c Although franchisees own the right to operate an enterprise for a fixed period, government may retain ownership of some assets. Ownership of private enterprises is on an indefinite basis.

Source: Adapted from EPAC 1995a.

Between departmental and private enterprise provision are different mixes of public and private involvement, such as commercialised or corporatised government enterprises, build-own-operate-transfer (BOOT) projects and franchises. The models in table 7.1 are stylised representations and involve a degree of abstraction. Moving along the spectrum of models towards private enterprise, more of the responsibilities and risks are borne by the private sector. In addition, the degree of independence from executive government (that is, cabinet ministers) normally increases.

Government-owned railways

Since 1991, government-owned railways have been subjected to various kinds of administrative and structural reforms. In most jurisdictions, reforms have involved either commercialisation or corporatisation. These programs have generally aimed to lift the performance of government railways and to promote competitive neutrality between government and private operations. In some jurisdictions, such reforms have been used to prepare railways for sale to private sector entities. Key reform initiatives in railways are summarised in chapter 3 and appendix D.

Commercialisation and corporatisation

Reforms involving commercialisation and corporatisation seek to introduce commercial disciplines and practices into the operation of publicly owned enterprises. These reforms require public enterprises to adopt objectives and incentives that emulate those facing private firms. Corporatised enterprises are expected to focus more on cost minimisation and efficient pricing. They are also required to introduce performance-based systems of rewards and sanctions for directors and managers. The IC (IC 1991a) set out a general model of corporatisation as a guide for governments (box 7.1).

Box 7.1 General model of corporatisation

- Provide clear, non-conflicting objectives relating to commercial performance only.
- Identify, cost and directly fund any CSOs from the government budget.
- Vest management in a commercial board of directors accountable to parliament through a minister.
- Introduce a system of rewards and penalties for managers related to performance and introduce performance-monitoring systems.
- Require the adoption of uniform and commercial accounting practices.
- Make authorities liable for all taxes and government charges and make dividends payable at levels equivalent to similar private companies.
- Remove constraints such as government employment policies and advantages such as government borrowing guarantees.
- Make corporatised authorities subject to the Corporations Law.
- Separate out regulatory functions, introduce effective natural monopoly regulation and remove exemptions from the Trade Practices Act that do not apply to private companies.
- Remove regulatory and legislative barriers to entry.

Source: IC 1991a.

Corporatisation has been subsequently encompassed by the National Competition Policy (NCP). The Independent Committee of Inquiry into NCP (Hilmer et al. 1993) outlined a number of key principles for corporatisation. The Hilmer Committee gave particular emphasis to achieving competitive neutrality between government and private enterprises.

The main difference between commercialisation and corporatisation lies in the legislative framework. Corporatisation generally involves legislation which specifies the powers and responsibilities of the government enterprise (through its

board of directors) and executive government as the dominant shareholder. The legislation aims to remove government from day-to-day control of the enterprise. The enterprise may be established under the Corporations Law, or as a statutory authority under its own or 'umbrella' legislation (NCC 1997c). Commercialisation does not usually have an equivalent legislative basis.

Most jurisdictions have established umbrella legislative frameworks for the corporatisation of government-owned railways. Since the mid 1990s, a number of public rail entities in New South Wales, Victoria and Queensland have become subject to such legislation (chapter 3).

The National Rail Corporation (NRC) and Australian Rail Track Corporation (ARTC) are the only government-owned rail organisations that have been incorporated under the Corporations Law, as recommended by the IC (IC 1991b). NRC contended that the 'standards of commercial behaviour required of such entities is more strictly sanctioned than in any special legislation' (sub. DR117, p. 13).

In the case of Westrail, the WA Government did not adopt the legal structure for corporatisation recommended by the Independent Commission to review Public Sector Finances in Western Australia (McCarrey et al. 1993) or the IC (IC 1991b).² The WA Government considered that some provisions of the Corporations Law were not appropriate for Westrail. In place of legislation, a formal performance agreement was reached between Westrail management and the State Government.

In principle, corporatisation is a more transparent and accountable way to pursue competitive neutrality and other objectives than commercialisation. That said, the commercialised Westrail has performed strongly compared to its corporatised counterparts in the 1990s (chapter 4). While a range of factors can influence relative performance, the selective adoption of specific elements of corporatisation and the relationship between Westrail management and executive government may have contributed to this positive outcome.

Is corporatisation sufficient?

As noted above, most government-owned railways have been commercialised or corporatised since the late 1980s. Despite achieving significant improvements in productivity between 1991-92 and 1997-98 (chapter 4), government railways still

² The McCarrey Commission considered the merits of two legislative frameworks. On balance, it supported the corporatisation of government enterprises under state statute but where the enterprises are being prepared for privatisation, provisions of the Corporations Law were thought to be more appropriate. The Commission identified Westrail as a candidate for corporatisation.

face several problems relating primarily to a lack of a full commercial focus and inadequate investment in the rail network. This suggests further gains are possible.

The limitations of corporatisation may stem from the way it has been implemented. Alternatively, there may be limitations to the model itself. Evidence to this inquiry provides support for both these possibilities.

A number of governments do not appear to have implemented the model as it was originally intended. Problems relate specifically to the objectives imposed by governments on their railways, the way in which CSOs have been specified, and the commercial freedom of boards to pursue profitable opportunities or cease loss-making activities.

Corporatisation was intended to strengthen the commercial focus of government railways. There was agreement among numerous participants (including Forsyth and Trace, FreightCorp, Tourism Council of Australia, Victorian Government and Westrail) that an increased commercial focus was still needed and was central to achieving further improvements in the rail industry.

Under corporatisation, governments are meant to provide rail enterprises with clear and non-conflicting objectives. This allows boards to focus on achieving those objectives and to be held accountable for their performance. It would appear that governments subject their railways, implicitly or explicitly, to multiple objectives. QR stated that:

It is particularly important to recognise that probably the most significant factor contributing to rail inefficiencies is the tendency for the rail industry to be bound up in certain political processes. These have objectives other than pure transport outcomes – ie social welfare, employment and regional development objectives.
(sub. 59, attach. 1, p. 2)

Further, in 1996, the Queensland Commission of Audit (1996) concluded that the performance of QR was constrained by government commitments and public expectations.³ As a result, it found that the corporatisation process — at that time — had not been effective in achieving the desired outcomes of introducing ‘arm’s length’ commercial relationships between Government and QR.

Introducing commercially-oriented charters does not preclude government-owned railways from delivering CSOs. If governments wish to pursue non-commercial objectives, this should occur on a transparent, contractual basis between government

³ QR was required to provide services to communities in all parts of the State served by the rail network, contribute towards the fulfilment of the Government’s policy agenda and honour commitments to its workforce precluding retrenchments and relocation (Queensland Commission of Audit 1996).

and the railway. The purchaser-provider framework required is discussed further in chapter 11 and appendix I.

While governments have implemented some reforms in identifying and explicitly funding CSOs (chapter 11), several participants have expressed concerns about cross subsidisation between profitable and unprofitable activities. Rio Tinto stated that:

The NSW government now provides some explicit subsidies to enable otherwise uneconomic passenger services to access the track, but suspicions about a ‘cross subsidy’ element remain. (sub. 58, p. 6)

The Rail Access Corporation (RAC) confirmed that, in 1996-97, access charges to the State Rail Authority of New South Wales (SRA) did not recover the costs of providing access and an effective cross subsidy was required from the Corporation’s more profitable activities (RAC 1997).

Similarly, commenting on the level of disclosure, the Queensland Mining Council stated that:

QR will tell you, ‘We’ve been corporatised. We calculate our CSOs correctly. We do not cross subsidise across the organisation and the rules are there to see in black and white.’ Our point is: if that’s the case, put the numbers on the table ... (trans., p. 624)

Another element of corporatisation is competitive neutrality — ensuring that government operators are not competitively advantaged or disadvantaged compared to their private sector rivals. As discussed in chapter 10, a number of participants expressed considerable doubts about whether government-owned railways operate on a competitively neutral basis. Some claimed that government railways have taken actions which could not be supported in a commercial environment. At a broad level, this indicates potential difficulties in achieving a commercial focus within government-owned railways.

There are also concerns that corporatisation has not ensured adequate levels of investment in railways. While investment has been occurring (for example, the mainline upgrade in Queensland), there is evidence that some government railways have not made, or been able to make, sufficient investment in rail infrastructure from a commercial standpoint (chapter 10).

At the same time, FreightCorp and RAC contended that commercial imperatives do apply — that is, investment is undertaken where adequate returns are expected. RAC argued that:

The real difficulty with investing in rail is not that there isn’t money. Rail Access Corporation has a very sound balance sheet and free cash flows, significant free cash flows to invest in the system. As a state-owned corporation we can invest where we’re

going to get a reasonable commercial return. ... There aren't very many profitable opportunities for investment, and so that's at the core of the problem. (trans., p. 651)

However, the findings of recent reports (HORSCCTMR 1998b, Maunsell 1998, Rail Projects Taskforce 1999) and evidence from participants (for example, Westrail) indicate that a major constraint facing government-owned railways is the lack of access to capital. As a result of this constraint, there are long delays before projects proceed or they may proceed in a piecemeal manner over a number of years as funding permits.

There are a number of possibilities as to why government railways may be capital constrained. In some cases, government railways may be subject to overall State borrowing limits constraining their ability to incur debt. Also, faced with large operating deficits for urban passenger services and observing generally poor returns in freight operations, State treasuries and ministers may consider that further equity funding cannot be justified. Poor returns could be exacerbated if rail owners are recording assets in their accounts at values in excess of their market value. Such practices could create an artificially high asset base making the financial performance of government-owned railways appear poorer than is actually the case.

Ultimately, the source of the capital constraint on government railways is not as important as the fact of its existence. Corporatisation is intended to allow government-owned enterprises to establish commercial capital structures and make investment decisions like any equivalent private corporation. Evidence that they are unable to do so points to problems with its implementation.

The commercial focus of government railways would be improved if they operated more in line with the original intent of the corporatisation model.

This would involve a number of changes to the current relationship between railways and government shareholders — the most important being a preparedness by governments to provide equity funding and/or allow railways to borrow on their own behalf for investment in rail infrastructure.

Limitations of the corporatisation model

Notwithstanding the gains which may be possible from a stricter application of the corporatisation model to government railways, the preceding discussion raises the issue of whether the rail industry tests the limits of this model. Compared to private ownership, the potential limits relate to the behaviour of governments in their role as shareholders.

Separation of ownership and control is characteristic of most larger private companies as well as government enterprises. Under the corporatisation model, performance monitoring by units within central agencies is intended to emulate, by administrative means, the performance assessment role fulfilled by debt and equity markets. In general, units monitoring performance within government operate with fewer resources and less information than that available to capital markets. As the original intergovernmental task force that codified the corporatisation model noted:

... none of the monitoring devices [of government] provide the continuous and unrelenting scrutiny which characterises private sector monitoring.
(TOIRGTE 1991, p. 26)

Measurement issues aside, there are questions about how governments interpret performance data and the extent to which they act upon this information. For instance, governments may be content to accept lower financial returns from their railways (and therefore refrain from enforcing sanctions) because there are compensating political benefits. Where such trade-offs are made, railways are not exposed to the same kind of commercial pressures and disciplines that confront private enterprises.

It is often difficult, and possibly unrealistic, for a minister or government to act in the same way as a commercial shareholder (notwithstanding the framework for delivering CSOs). The nature of the political process itself, and the expectations of the community, can mean that ministers seek to be involved, or are drawn into matters that are the proper responsibility of boards.

The shortcomings of the corporatisation model were discussed by some participants. John Hearsch Consulting noted that:

Corporatisation and the appointment of 'commercial' Boards of Directors has been implemented in some instances with a view to the interface with government being at arm's length. However, experience would suggest that this objective is rarely achieved in practice unless the politicians and bureaucrats concerned exhibit uncharacteristic restraint! (sub. DR120, attach. 1, p. 24)

And the Victorian Government argued that:

... even if corporatised entities are set up on a sound commercial/company basis and even if politicians do not interfere, the ultimate discipline of a stock market price is lacking. A falling share price is a warning to managers that they must lift their performance or face the threat of take-over and hence loss of their jobs. There is no equivalent with a government owned business. (sub. DR118, p. 6)

The corporatisation model has inherent limitations, such as the inability of governments to behave in a commercial way and remain at arm's length from their railways. As a result, the commercial incentives and disciplines confronting corporatised railways are diluted.

Government procurement

Under the traditional departmental or government enterprise model, governments both funded and provided rail services. In the past decade, however, there has been a move away from exclusive in-house provision. Under the procurement model, governments purchase services from public enterprises or the private sector under contract. These issues have been addressed in an inquiry conducted by the IC in 1996 into the use of competitive tendering and contracting (CTC) by public sector agencies (IC 1996).

Government-owned railways have increasingly adopted CTC in the 1990s. A number of services are now provided by the private sector. Although contracting out has occurred primarily in the area of maintenance, some ancillary services, such as cleaning and catering, have also been outsourced (table 7.2). There has been subcontracting of some rail operations, for example, Northern Rivers Railroad hauls wagons containing fly-ash between Grafton and Murwillumbah as a subcontractor for FreightCorp (*Network Rail*, Dec/Jan 1998, p. 17).

CTC is a means of introducing market pressures into areas where competition was previously absent. Competition is introduced through the bidding process and drives providers — be they public or private — to adopt efficient methods of service delivery. Even where contracts are awarded to in-house bidders, the threat of competition can provide powerful incentives to improve cost-effectiveness (Rimmer 1994). The main benefits of CTC are argued to include lower costs, improved service delivery and quality, and greater flexibility (King 1994).

Contracting with the private sector generally involves the transfer of some commercial risk from government (such as the risks associated with the cost of construction and/or operation). There are likely to be stronger incentives to contain costs under contracted private provision where contracts are properly specified.

Table 7.2 Competitive tendering and contracting by government-owned railways, 1991 to 1999^a

<i>Jurisdiction</i>	<i>Date</i>	<i>Nature of reform or policy initiative</i>
New South Wales	1992	Service contract let for the provision of locomotive services. The private sector to own and maintain the locomotives and the SRA to lease them on a per kilometre basis.
	1992-93	Proposed private sector maintenance of Endeavour/Xplorer diesel railcars with potential for extension to XPTs.
	1993	Maintenance of electric passenger rollingstock at the SRA Clyde/Elcar workshop contracted out to the private sector.
	1993-94	Government released its contracting and market testing policy to encourage the adoption of contracting in the public sector.
	1996	Catering services on Countrylink trains outsourced.
	1997-98	RAC let several contracts for maintenance work on the state rail network.
	1998	Northern Rivers Railroad contracted to haul fly-ash in northern New South Wales.
Victoria	1992	Public Transport Corporation allowed to bid for NRC contracts.
	1996	Operation of Bendigo railway workshops contracted out.
Queensland	1992	Significant inspection tasks transferred to industry and private sector organisations.
Western Australia	1992-93	Instruction circulated to all public sector agencies to identify and pursue opportunities for letting services to competitive tender.
	1996	Westrail contracted out track maintenance and development work. Major locomotive repairs and servicing of locomotives and wagons contracted out.
	1996-97	Cleaning of all country passenger rollingstock, catering and maintenance of Prospector railcars and refurbishment of Australind railcars transferred to the private sector.
	1997-98	Gantry crane operations at Kalgoorlie operated under contract to a private sector operator.
South Australia	1995	Some public transport services competitively tendered. TransAdelaide track re-sleeping activities contracted out.
	1996-97	Service area franchise contracting for all metropolitan public rail services implemented.
	1993-99	NRC outsourced locomotive maintenance, some wagon maintenance, terminal equipment maintenance, information technology development and operations, and a number of corporate functions.
Commonwealth	1998-99	ARTC contracted out track maintenance.

^a This list is not exhaustive and not all contracts were tendered.

Sources: ARTC, sub. DR97; IC 1991a (various years); *Network Rail*, Dec/Jan 1998, p. 17; NRC, sub. 53 and sub. DR117; PC 1998c; WA Government, sub. 60.

Several participants pointed to cost savings from the use of CTC in railways. NRC attributed productivity gains to several initiatives including outsourcing of most non-core functions (sub. 53). The Victorian Government noted that the Public Transport Corporation had achieved gains from the contracting out of non-core activities such as information technology (sub. 82). And ARTC outsources a significant proportion of its activities to the private sector:

... the result of which is an ability to reduce access pricing by an average of 7 per cent in real terms since the advent of ARTC's predecessor (AN Track Access) in 1995. (sub. DR97, p. 9)

According to ARTC, other gains from a commercially focused maintenance and network management effort have included increased network capacity, improved service quality and changes in train operating parameters (such as increased train length) which enable operators to derive above rail productivity benefits.

In New South Wales, a strategic review of RAC revealed that 'substantial cost reductions could be achieved from productivity gains and other efficiencies in the Infrastructure Works and Maintenance Program' (RAC 1997, p. 9). A priority of RAC has been to introduce contestability into this program. However, in July 1998 the NSW Government instituted a one year moratorium on the contestability program to allow Rail Services Australia time to implement the necessary structures to enable it to compete on an even footing with the private sector (sub. DR102). In June 1999, the Government partially lifted the moratorium by allowing competition for the provision of maintenance services on the Bondi Junction to Waterfall line in Sydney and the Hunter Valley lines.

While several government-owned railways have applied CTC to some of their activities, QR has taken a different approach:

Just as we went against the general trend in Australia on the subject of integration, so too we went against the trend by investing in core activities like workshops and track maintenance. Retention of a full range of railway technical support services has been a major plank in our strategy to remain competitive ... (O'Rourke 1999, p. 4)

The potential benefits available from CTC are not guaranteed. In some cases, the in-principle advantages of contracting out may be dissipated by a greater degree of contractual dispute (EPAC 1995b). For instance, a low bid may win a contract but subsequent renegotiation may raise the final cost. Another issue is the period of the contract which determines the frequency of competitive bidding. Aside from price, it is important that contracts contain appropriate incentives or conditions to ensure service quality. Governments may also need to retain the requisite skills in-house to supervise the performance of service providers against contractual commitments. Most of these issues can be addressed by well designed contracts, tendering systems, and monitoring processes.

The employment and regional impacts of using contracting out in government railways are discussed in chapter 11.

Providing that tendering systems, monitoring processes and contracts are well designed, the application of contracting out in rail transport can lead to improvements in efficiency because of the stronger commercial disciplines confronting the private sector.

BOOT-based approaches

Under BOOT based approaches, the private sector finances and builds an infrastructure facility in return for the right to operate the facility and charge users a fee. The fees or user charges are usually approved and regulated by government. The use of BOOT-based approaches in rail transport is a recent phenomenon in Australia with only a small number of projects currently operating or under construction.

There are a number of key variants within BOOT-based approaches, including Build-Own-Operate (BOO), BOOT and Build-Transfer-Operate (BTO).

- BOO projects remain privately owned facilities in perpetuity. An example is the Skitube in the Snowy Mountains in New South Wales (HORSCCTMR 1998b).
- Ownership of a BOOT project transfers to government at the end of a pre-determined period. The New Southern Railway and the Brisbane Airtrain are examples of such projects (box 7.2).
- Under a BTO scheme, the government takes ownership of the project on completion and leases it back to the private sector.

The key difference between BOOT-based approaches and contracting out under public ownership is that, under a BOOT structure, the private sector provides at least some of the finance for the venture and assumes some part or all of the project's risk. The allocation of risks between the private sector and government is normally specified in the contract. BOOT-type projects may be characterised as project rather than network privatisations. These approaches can be used to upgrade existing infrastructure or to add new segments to networks.

BOOT-type projects appear to overcome some of the limitations of contracting out under public ownership, especially access to adequate capital (either debt or equity) and the incentive to dispute contract provisions. As noted earlier, the public sector may have difficulty in providing dedicated funding for large scale infrastructure projects stemming from budgetary or borrowing constraints.

Box 7.2 **BOOT projects: airport rail links**

New Southern Railway

The \$800 million Sydney Airport Rail Link is Australia's largest BOOT railway project. It has a five year construction time table which commenced in July 1995. The project is a ten kilometre railway, mostly underground, running from Central Station to Sydney Airport, then joining the CityRail Illawarra and Glenfield lines at Turrella.

The project involves public and private sector collaboration in ownership, operation, cost and risk of development. The NSW Government will fund and own the tunnel, track, signalling and communications systems at a cost of about \$540 million. The track will be owned by the Rail Access Corporation and the rollingstock owned and operated by the State Rail Authority of New South Wales (SRA). Transfield and Bouygues through the Airport Link Company will fund, own and operate the four underground stations (costing around \$250 million) for 30 years after completion in 2000.

The fares applying to the Sydney Airport Rail Link will be in two parts: a train fare and a station fare. The train fare is the normal SRA fare (which is subject to review by the Independent Pricing and Regulatory Tribunal); concession fares continue to apply. The station fare is a special fare which provides the revenue for the Airport Link Company. All fares will be contained in the one ticket. There will be no extra charge for through passengers travelling on the link as part of the integrated CityRail network.

Brisbane Airtrain

The \$190 million Brisbane Airport rail link will be Queensland's first BOOT rail development. Transfield in partnership with Macquarie Bank has formed the Airtrain Citylink consortium to build, own and operate an 8.5 kilometre rail link providing direct passenger services from Brisbane Airport to the Brisbane CBD and the Gold Coast. It links into the Citytrain network run by Queensland Rail.

Transfield will be responsible for design, construction, operation and maintenance. Design work began in early 1999. Construction is expected to begin later in 1999 and take just over two years to complete. Airtrain Citylink will own, operate and finance the project for 35 years after which the asset will revert to the Queensland Government at no cost. There is no government contribution or support of revenue streams.

Sources: Office of the Queensland Premier 1999; Transfield Maintenance, Melbourne, pers. comm., March 1999; *Transit Australia*, May 1998, pp. 99-102.

Compared to the contracting out approach, BOOT-type projects provide secure funding, bring generally sharper incentives for efficiency and generate synergies from bundling construction and operation with finance. As equity partners, BOOT contractors have the incentive to avoid excessive contract disputation and to consider the life cycle costs of the asset (EPAC 1995a).

The efficiency incentives facing BOOT contractors will depend on revenue arrangements and the associated risk exposure. Regulation of fares and payment of subsidies, for example, can affect contractors' incentives to seek cost savings and encourage growth in patronage. The Bureau of Industry Economics (BIE) noted that price caps (which restrict fare increases to the rate of growth in the consumer price index less a productivity factor) can introduce incentives to operate at least cost while limiting the scope for monopoly pricing (BIE 1995a).

Financial costs, including the cost of capital and transaction costs, are an important consideration in selecting the form of provision. Network risks for BOOT projects in particular may add to the cost of capital. Because a BOOT project is often part of a wider infrastructure network, changes in other segments of the network may affect the project's traffic flows and revenue. The Commonwealth Department of Finance and Administration noted that BOOT contracts tend to protect against competition from alternative routes (sub. 65). Moreover, transaction costs are typically high for BOOT projects because of the legal and financial complexity of contractual arrangements between numerous parties (EPAC 1995a).

Transaction costs are also a key consideration in selecting between BOOT or BOO projects. Contracts for BOOT projects will need to specify the condition of assets at the time of transfer back to government. Otherwise, the operator may be reluctant to maintain or replace assets as the transfer date approaches. BOO projects do not require these additional contractual provisions and therefore have greater flexibility in terms of investment and maintenance than BOOT schemes.

Under BOOT-type arrangements, there may be additional efficiencies compared to contracting out resulting from synergies created by combining construction, operation and finance.

Franchising

Another model of service delivery is franchising.⁴ Under this approach, government grants the right to operate a service for a fixed period to the franchisee. The right is usually won through a competitive bidding process.

Where transport markets exhibit natural monopoly characteristics, franchising may be a way of introducing competitive pressures. This occurs through periodic competitive bidding for the franchise. That is, an exclusive franchise is established

⁴ Thompson and Budin (1997) apply the term 'concessioning' to leasing or affermage, franchising, and traditional concessioning.

and firms compete for the right to serve the franchise area. This is known as competition for the market, as distinct from on-going competition within the market.

There has been a recent international trend towards the franchising of rail services. A number of Latin American countries (including Argentina, Bolivia, Brazil, Chile and Mexico) have applied franchising to railways, as have some African countries and Great Britain. As the franchising of passenger services in Victoria has only recently commenced, the overseas experience — particularly in Argentina and Great Britain — is used as a guide to the potential outcomes of franchising.

International experience

Proponents of franchising contend that the potential benefits include enhanced efficiency in operations and maintenance, improved service quality, greater innovation, market development and revenue growth, increased investment and reduced government financial support.

Many of these benefits have been realised in Argentina where rail services were franchised in the early 1990s (appendix E). The World Bank, which has been involved in rail reform in Argentina and elsewhere, examined the early performance of the franchises. According to Carbajo and Estache (1996), the overall results have been positive — many services have improved, traffic volumes have increased, and subsidies have been reduced (box 7.3).

In Great Britain, passenger train franchises began operating in the mid-1990s. The Office of Passenger Rail Franchising reported that the two key measures of train operators' performance — reliability and punctuality — had generally improved in 1996-97 compared to 1995-96. However, punctuality has since deteriorated whereas reliability has been broadly maintained. Strong growth in passenger numbers has also led to overcrowding on some commuter trains serving London (OPRAF 1999a, 1999b and 1998).

The infrastructure owner, Railtrack, improved network performance in terms of train delays attributable to Railtrack between 1995-96 and 1997-98. But, its activity in renewing assets (including some track components, signalling and stations) has been below expectations and there has been little increase in network capability (Booz-Allen & Hamilton 1999).

Box 7.3 Rail franchising: The Argentine experience

Before recent reforms, Argentina had a large public sector railway, Ferrocarriles Argentinos, which operated a national network of 35 000 kilometres and employed 92 000 people. By 1990, the railway was losing about US\$1.4 billion a year (1992 US dollars) and its fixed assets were in poor condition. Much of the track was in a fair to bad state and only half the locomotives were available for service. As a result, the railway was losing traffic and market share.

In 1990, the Argentine Government and the World Bank agreed on a plan to restructure the railway into several separate freight and commuter rail networks, concessioning (that is, franchising) the networks, rationalising intercity passenger services, and other measures (appendix E).

Operating as franchises, most of the rail freight businesses appear stable but none are highly profitable as traffic density on Argentina's freight railways is low. Traffic has grown in rail freight services. However, because demand for these services will not be sufficient to justify promised investment, the level and timing of the investment program are being renegotiated. That said, the freight businesses have recorded strong improvements in performance in terms of labour productivity, service quality and freight rates. There has also been a reduction in the public deficit of about US\$600 million a year.

Traffic growth following franchising in Argentina

<i>Freight volume, major lines, 1990–1995</i>		<i>Passengers carried, 1993–1995</i>	
	<i>Per cent</i>		<i>Per cent</i>
Nuevo Central Argentino	40	SUBTE (subway)	28
Ferrocarril Mesopotamico	50	Urquiza	36
Buenos Aires al Pacifico	92	San Martin	64
Ferroexpreso Pampeano	130	Belgrano Sur	69
Ferrosur Roca	160	Mitre	74
		Roca	83
		Belgrano Norte	408

The franchising of urban passenger services has seen recorded patronage grow strongly. Suburban and metropolitan demand for passenger rail services is much greater than anticipated and the government specified investment program is proving to be inadequate. On the other hand, most intercity rail passenger services have ceased operating.

Sources: Thompson 1997; Thompson and Budin 1997; Carbajo and Estache 1996.

Recent assessments have pointed to a number of problems with rail franchising and privatisation in Great Britain including inappropriately set performance benchmarks, shortcomings in liability regimes and weak or nonexistent incentives to invest in infrastructure and rollingstock (*The Economist*, 3 July 1999, pp. 57–60; Trace 1999).

Franchising processes

The franchising process involves drafting contracts, designing the tendering system, and developing procedures for monitoring contracts.

Contract specification

Designing the franchise contract requires consideration of the period of the franchise as well as the responsibilities of the franchisee and government.

The period of the franchise contract is an important parameter which can affect incentives to invest. In general, the private sector will not finance assets whose service lives exceed substantially the franchise period (Thompson and Budin 1997). Kain argued that, in Great Britain, franchisees have little incentive to invest voluntarily in rollingstock:

... a standard franchise length of seven years, the acquisition lead time and the high cost of trains work against investment in rollingstock purchase. The payback period is far longer than the standard franchise length, which adds to the investment risk, as the TOC [Train Operating Company] must bear all the risk of a low resale value at the end of a franchise period on the premise that the TOC can fail to re-win its franchise. (Kain 1998, p. 256)

The key advantage of short franchise periods is that they allow more frequent competition for the market, thereby maximising the competitive pressures on the incumbent to perform (Jones et al. 1993). On the other hand, franchisees with long term contracts normally face fewer constraints to investment and innovation. In deciding the terms of franchises, governments need to weigh up the benefits from the frequency of competitive bidding against the possible effects on investment risks and incentives.

The responsibilities of government (the franchisor) and the franchisee are specified in the contract. Franchising generally involves the transfer of commercial risk to private firms, thus differentiating it from contracting out. In the case of franchises in Great Britain, Kain noted that:

Franchisees shoulder the commercial risk, that is, both cost control and revenue box risk. In this sense, the government has shifted the risk to the private sector ... (Kain 1998, p. 256)

If overly prescriptive or regulated, franchise contracts may stifle private sector innovation and investment, and reduce potential efficiencies. Poorly designed contracts may see private operators engage in opportunistic behaviour, such as allowing assets to run down towards the end of the franchise period.

Tendering and monitoring systems

The winning bid may be selected on the basis of the highest positive bid, lowest subsidy requirement from government (that is, minimum negative bid), lowest tariff structure and/or other criteria. Governments can choose between bidding in a single round or bidding in stages — a pre-qualification round followed by shortlisting and final bids.

There is also the issue of whether to allow cross ownership of bus, tram, ferry and rail services. The level of competition between modes may diminish where a company operates different services in the same geographic area.

Once franchises have been awarded, governments will need to monitor the performance of rail services against contractual commitments. Contracts may include rewards and penalties where performance exceeds or falls short of that promised. In Great Britain, passenger franchises incur financial penalties for poor running times. The responsibility for monitoring contracts may require the creation of a new body or be given to an existing agency.

Asset transfer arrangements are crucial to facilitating competitive outcomes in subsequent rounds of tendering. Where the franchisees own assets (such as rollingstock), there is a risk that they may refuse to sell the assets or ask too high a price if they are unsuccessful in the next bidding round. To avoid such situations, governments need to consider how asset transfer will occur at the end of franchise periods and draft contracts accordingly.

The Victorian model

The Victorian Government is seeking to achieve further improvements in the passenger rail system in Victoria through franchising. It stated that:

The proposed franchising structure helps overcome the lack of competition inherent in the urban rail system because of its natural monopoly characteristics. Competition in the bidding stage for exclusive franchise rights substitutes for competition in the retail end of the market. (sub. 82, p. 7)

The Government studied the lessons from rail franchising in Great Britain and developed its own ‘franchising and leasing model’. Under this model, the urban train system was horizontally separated into two franchises (Bayside Trains and Hillside Trains) to optimise scale economies and permit ‘competition by comparison’. These franchises are vertically integrated operations; that is, the train companies will control both the rollingstock and infrastructure (track, signalling and stations) for the life of the franchise, unlike the British model under which Railtrack owns and manages the infrastructure.

As the passenger businesses in Victoria were loss-making and required government subsidies, the Victorian Government considered that a conventional sale might not be appropriate and negative bids should be sought. The successful bidders for the rail franchises (Bayside Trains, Hillside Trains and V/Line Passenger) were announced in June and July 1999 (chapter 3). They will operate train services, invest in rollingstock and receive subsidies during most or all of the franchise periods.⁵

The franchisees have entered into franchise agreements with the Victorian Government. The agreements include requirements for passenger service levels, first and last services, maximum fares, service intervals and operational performance (in terms of punctuality and reliability, capacity, quality of service and journey times).

In the case of the urban train franchises, the infrastructure will be leased from the Victorian Government. The leases set out the terms upon which the franchisees use the infrastructure (sub. 82). The franchisees will also be accountable for maintaining and renewing the track and signalling (sub. DR118). In the case of V/Line Passenger, the franchisee will lease the main country stations and enter into track access arrangements with Freight Victoria.

The Victorian model incorporates an operational performance regime under which franchisees can earn bonuses or incur penalties based on their actual performance in relation to punctuality and reliability benchmarks. The model contains tougher penalties than exist in Great Britain (sub. DR118). In addition, there are financial incentives for increasing patronage; that is, franchisees can receive payments from the Government for achieving passenger growth above specified threshold levels. Fare regulation and the declining pattern of subsidies are also expected to generate pressures to achieve cost efficiencies and growth in patronage.

The franchisees will invest in new rollingstock, upgrade the existing train fleets and undertake some investment in infrastructure. At the expiry of the franchises, the rollingstock will revert under lease to the Government so that it can be transferred to the winners of the second round of bidding, if required.

The State Government expects that franchising will result in improved service quality, increased service levels, patronage growth and a significant reduction in government financial support. The Victorian Auditor General (1998) noted that the content of the contracts will largely determine the success of a franchised public transport system. The franchising process in Victoria and the subsequent performance of franchisees will provide guidance on the usefulness of this approach for rail operations elsewhere in Australia.

⁵ National Express is expected to make payments to the Government in the last four years of its Bayside Trains franchise.

Franchising may generate further gains compared with contracting out because franchisees usually bear revenue risk, enhancing their incentives to expand the market.

Privatisation

The term ‘privatisation’ has been used to describe various forms of private sector involvement in activities previously dominated by government. In this chapter, it refers to the sale of government-owned rail operations (and transferring control of these assets) to the private sector.

The Commonwealth Government has divested itself of a significant part of its investment in railways, whilst retaining the debt. Several component assets of the former Australian National Railways Commission (AN) were sold to private sector interests in November 1997. In February 1999, the Victorian Government sold its V/Line Freight business (table 7.3).

Table 7.3 Privatisation of rail assets, Australia, 1997-98 to 1998-99

<i>Assets</i>	<i>Sale price</i>	<i>Private operators</i>
	\$m	
Victorian freight	163	Freight Victoria ^a
SA freight	57	Australia Southern Railroad ^b
Tasmanian freight	22	Tasrail ^c
Interstate passenger	16	Great Southern Railway ^d

^a Owned by RailAmerica. ^b Owned by Genesee & Wyoming. ^c Owned by the Australian Transport Network. Shareholders include Wisconsin Central Railroad and Tranz Rail. ^d Consortium includes Serco Asia Pacific and GB Railways Australia.

Sources: Australian Financial Review, 23 February 1999, p. 5; Harris 1998.

Some State Governments and the Commonwealth Government are intending to sell other rail freight operations in 1999. NRC is being prepared for sale and the WA Government is planning to sell the freight operations of Westrail.

Private firms apply a commercial approach to the provision of services. That is, they will only provide services or invest in new capacity if commercial returns are expected. Their primary focus is on improving performance, profitability and the market value of their assets.

As discussed earlier, governments often direct their businesses to pursue a number of objectives which may impinge on their commercial focus and performance. The Commonwealth Department of Finance and Administration noted that:

One of the causes of AN's debt, is its operation of non-commercial services. Selling AN to the private sector will ensure that a commercial discipline is applied to rail services and activities. (sub. 65, p. 17)

Some participants argued that the incentives facing private firms are stronger than those for corporatised enterprises. Australian Transport Network (ATN) stated that:

... under private ownership greater incentives and accountability can be ensured through management shareholding and bonus payments on the performance of the company. Ownership becomes contestable with access to the capital markets for equity funding and the company's board and management are exposed to the scrutiny of stockbrokers and analysts. (sub. 25, p. 2)

As noted by McKillop, freight markets are evolving towards the provision of completely integrated services (sub. DR90). However, retaining rail freight operations under government ownership may limit their ability to further integrate into the logistics chain. NRC argued that such integration is not possible without substantial privatisation:

... in order to be integrated into the logistics chain, it is going to be necessary for mergers and alliances and associations to be built between corporate entities who are now responsible for and control parts of that logistics chain ... Under public ownership all of those sort of changes in the corporate boundaries and structures are extremely difficult. (trans., p. 1002)

Privatisation also creates opportunities to change the leadership and culture of rail enterprises. The Victorian Department of Infrastructure contended that the leadership of some government-owned rail organisations is an impediment to further improvements and that a change in ownership offers a solution, by introducing new people and a new mindset into railways (trans., pp. 952-953).

From the perspective of governments, privatisation may be of benefit as it transfers commercial risk to the private sector.

Recently privatised railways in Australia — based on early indications — appear to have improved their performance compared to the government-owned railways they replaced. According to the CRT Group, the initial evidence suggests that privatisation has led to actions to ensure profitability, an immediate assessment of the prospects of contracting out non-core elements, injection of private capital and a more aggressive approach to innovation — both technical and managerial (sub. 20).

The private owners of Tasrail have increased traffic volumes and are actively seeking new contracts. They are investing in rollingstock and infrastructure and have introduced new labour arrangements (box 7.4). The Commonwealth Department of Transport and Regional Services noted that Tasrail is profitable for the first time in 130 years (sub. 76).

Box 7.4 Rail privatisation: Tasrail

ATN purchased the Tasmanian rail system from the Commonwealth Government as part of the AN sale. ATN has been operating Tasrail since November 1997. Tasrail's revenue has increased by approximately 50 per cent, returning the business to profitability. ATN announced an operating profit of \$1.2 million for its first seven months of operation.⁶ The improved profitability reflects revenue growth and cost reductions.

Tasrail has increased its traffic volumes significantly. It has won contracts to haul logs and containers. Some of the revenue growth stems from its purchase of the Emu Bay Railway for \$7.8 million from Pasminco in 1998. It is also exploring opportunities for transporting dairy, mining, pulp and paper products.

Tasrail has commenced an investment program aimed at improving reliability of service and lowering operating costs. It plans to invest about \$40 million by 2001. A re-sleeper program was initiated immediately after purchase and a new state-wide communications system was installed. Twenty six refurbished locomotives equipped for driver only operation, will replace the ageing Tasrail fleet. Additional wagons have been purchased and many existing wagons are being modified. Following some tunnel and bridge repair work, the Scottsdale line in north-east Tasmania was reopened to meet expanding forestry and mining industry demand. The Wiltshire branch line from Burnie to the north-west has been reopened.

Tasrail, which employs about 200 people, has also changed labour arrangements. It has introduced driver only operation, individual contracts and bonuses.

Sources: ATN, sub. 25; ATN 1998; Daily Commercial News, 4 June 1999, pp. 9-10; *Network Rail*, Oct/Nov 1998, p. 17; *Network Rail*, Feb/Mar 1998, p. 17; Harris 1998; *Rail 2000 Newsletter*, No. 49, January 1999, pp. 5-6.

ASR, which purchased the mainland freight assets of AN, has also introduced new labour arrangements such as multi-skilling and incentive schemes such as profit-sharing. At ASR, employees perform a range of tasks:

... drivers, for example, start and inspect their own locomotives in many cases. They also plan their shunting work, interact with the customers and do minor field repairs on the locomotives and wagons. (Chabot 1998, p. 3)

⁶ Up-to-date information on financial performance is not available.

ASR has committed to spending \$62 million on locomotives, track and rollingstock over five years (Harris 1998).

Great Southern Railway (GSR), which operates passenger services, employs around 270 people for station and on-train services. A further 100 people are employed full-time by subcontractors who provide catering, laundry, cleaning and maintenance services. While GSR's Overland service continues to make losses, the Ghan and Indian Pacific services now generate positive margins which are sufficient to cover fixed costs. GSR expects to become profitable in the next year (sub. DR95).

These initiatives follow a similar pattern to that observed in New Zealand where the railway was privatised in the early 1990s. Although the corporatisation of the New Zealand railway generated significant improvements in performance, privatisation led to further gains (box 7.5).

In the Australian context, the fact that private consortia have purchased generally loss-making government railways without public subsidies (and in some cases for relatively high prices) suggests the new owners expect to achieve gains in efficiency.⁷ That is, when the sale value exceeds the present value of the profits (or losses) under government ownership, this differential is an indication that enterprise performance is likely to improve under private management.

Rail privatisation in Australia has seen smaller assets being sold first. In these initial sales, vendor governments have had to deal with a range of often complex issues. This experience and the lessons learned may prove useful to governments intending to privatise larger rail operations.

When contemplating privatisation, governments need to be aware of the trade-off between maximising sale value and promoting competition. Government enterprises which earn monopoly profits are likely to fetch a higher price than if they faced competition. As Baumol stated, when a government-owned enterprise is put up for sale:

... those who are responsible for overseeing the transaction are likely to consider themselves obligated for the sake of the public interest to seek to obtain for the property as high a price as can be gotten. But it is obvious that higher price bids can be elicited if the property is offered along with a monopoly license that is protected against the entry of rivals. (Baumol 1993, p. 7)

⁷ Both AN and V/Line Freight were loss-making businesses before privatisation. AN recorded an operating loss (before abnormal items) of \$57 million in 1996-97 (AN 1997) and V/Line Freight reported an operating deficit (before abnormal items) of \$15 million for 1997-98 (V/Line Freight 1998).

Box 7.5 Rail privatisation in New Zealand

In 1982, responsibility for managing the New Zealand railway was shifted from a government trading department to a statutory corporation with largely commercial objectives. It later became a state-owned enterprise. In the early 1990s, the New Zealand Railways Corporation underwent financial restructuring. The Government formed a new company, New Zealand Rail Limited, to run the core rail freight, rail passenger, and inter-island ferry services previously owned by the New Zealand Railways Corporation.

New Zealand's rail system achieved significant improvements in customer focus, efficiency and financial performance over the 10 years from the time the business was corporatised. Between 1983 and the early 1990s, rail freight rates were reported to have declined by around 50 per cent in real terms, customer surveys indicated improvements in service quality, and employment had fallen by more than 70 per cent.

New Zealand Rail was sold to a New Zealand-US consortium in 1993 and now operates as Tranz Rail. Since privatisation, the company has introduced new labour agreements and work practices, sold non-core assets, re-branded its corporate identity, worked to improve customer satisfaction and upgraded its technology and asset base. Significant investment in infrastructure, equipment and technology has allowed the company to improve its service delivery by reducing freight transit times, increasing freight capacity and increasing operational efficiency. Labour productivity, asset utilisation, traffic levels and profit have all increased since privatisation.

Performance improvements since privatisation, 1993–1998

	Per cent
Labour productivity	47
Asset utilisation ^a	44
Traffic levels	32
Operating profit	85

^a Number of trips per month for freight cars.

Sources: ATN, sub. 25; Duncan and Bollard 1992; Small 1998.

Thus, governments should consider the competitive environment within which their railways operate, including the structure of enterprises, access regimes and the degree of competition from other modes. Selling a monopoly business without effective regulation or adequate track access arrangements may artificially inflate the sale price, but may ultimately impose costs on industry and the community. Regulation issues are discussed in chapter 8.

In many freight markets in Australia, rail operators face competition from other operators and/or transport modes. Given this environment and considering the limitations of corporatisation, the remaining government-owned freight operations

are strong candidates for privatisation. The experience to date with the recently privatised rail operators in Australia has been encouraging.

In the case of the main coal lines in New South Wales and Queensland (where market power exists), governments could introduce periodic competitive bidding among private sector entities for the right to haul coal (chapter 6). To allow for franchising, privatisation of government-owned freight operations in these States would require specific arrangements for reserving the rollingstock used on the coal lines. As discussed above, it is essential that governments resolve asset transfer issues to ensure competitive outcomes in subsequent bidding rounds.

In addition to budgetary effects, governments should take account of the broader costs and benefits that are likely to result from selling their railways. Although privatisation of a railway may generate an overall gain to the economy, it could still have adverse impacts on railway employment and regional communities. In these situations, adjustment issues will need to be considered (chapter 11).

Once the decision to privatise is taken, it is important that governments specify the time frame within which privatisation will occur. Failure to do so may generate uncertainty and reduce investment in the rail industry. Some private operators are waiting for privatisations to occur before making further investments. In the case of NRC, some participants (Capricorn Capital Limited and the Austrac Group; Specialized Container Transport) have expressed concerns about the retention of assets in excess of NRC's requirements.

In deciding to privatise railways, governments need to consider the competitive environment, including the extent of intermodal competition and the effectiveness of regulation. There is a strong case to privatise rail services operating in competitive transport markets.

To sum up, private sector involvement in railways can take a variety of forms, including through CTC, BOOT-type schemes, franchising and full privatisation. The appropriateness of different forms of private sector involvement will differ, depending on the characteristics of the specific rail network and transport market.

Private sector participation has the potential to deliver net benefits to industry and the wider community, provided that governments pay adequate attention to contract specification, bidding processes, monitoring systems and regulation. Governments should also consider labour and regional adjustment costs (chapter 11).

Governments which own railways should pursue further private sector involvement (through contracting out, BOOT-type arrangements, franchising or privatisation) as an integral part of their approach to rail reform.

All remaining government-owned freight operations should be privatised, with special arrangements for the rollingstock used on the main coal lines.

7.3 Taxation issues

The extent and form of private sector involvement can be influenced by taxation arrangements. Participants' concerns in this area centred on:

- the Infrastructure Borrowings Tax Offset Scheme; and
- s.51AD of the *Income Tax Assessment Act 1997* (Cwlth).

Infrastructure Borrowings Tax Offset Scheme

Several participants (including Patrick, QR and the WA Government) supported the use of tax incentives as a mechanism to encourage private sector investment in rail infrastructure. Patrick stated that:

If the government wishes to foster the growth and development of rail, then tax incentives and BOOT schemes would induce more participation from the private sector. (sub. 63, attach. 1, p. 13)

Infrastructure projects, such as BOOT schemes, are normally undertaken by stand-alone companies, usually formed as a joint venture between several parent companies. Under the stand-alone company structure, tax losses can only be offset against income earned by the project and not against other income earned by the parent companies. As infrastructure projects are often characterised by long construction and start-up periods before any income is earned, any tax losses must be capitalised and offset against future income earned.

However, the real value of the tax losses (when carried forward) will be lower than when they were initially incurred, especially in periods of high inflation. Some have argued that stand-alone companies are tax disadvantaged due to their inability to access tax losses during the construction phase of projects.

To address this perceived tax disadvantage, the Commonwealth Government in 1992 introduced the infrastructure borrowings program. In 1997, this program was replaced by the Infrastructure Borrowings Tax Offset Scheme which aims to encourage private sector investment in land transport infrastructure by reducing finance costs. The scheme allows infrastructure proponents to apply:

... for a tax rebate, described as a tax offset within the ITAA [Income Tax Assessment Act] 1997, which is provided to the project's resident infrastructure lenders. In return the infrastructure proponent (the borrower) receives a reduction in finance costs in the form of lower interest rates or other benefits, and forgoes tax deductibility on interest payments associated with the loan. (DTRS and the ATO 1998, p. 1)

Rail projects that have applied for the rebate include the Alice Springs-Darwin Railway, Bondi Rail Extension, Chatswood-Parramatta Rail Link, Snowy Mountains Railway, Surat Basin Rail Link and Sydney-Canberra Very High Speed Train (sub. 76). Rail projects were not among the first projects that qualified to receive assistance under the rebate scheme. The Commonwealth Government is in the process of assessing another round of applications.

However, some studies have placed the rationale for such tax concessions under question. Freebairn doubts that tax losses represent a convincing argument for special concessions to infrastructure investors:

Because over a half of other investors [apart from infrastructure investors] also have to carry forward measured tax losses, and because the effect of loss carry-forward is to increase effective tax rates by only a few percentage points, even stand-alone project infrastructure investments are unlikely to face effective tax rates much above the average for other corporate investments. (Freebairn 1995, p. 16)

And, Sieper (1995) estimated that effective tax rates are broadly equivalent for stand-alone infrastructure projects, other infrastructure projects, and plant and equipment with effective lives between 5 and 30 years.

Both Freebairn and Sieper argued that, while stand-alone companies cannot access tax losses during the construction phase, this disadvantage is largely offset by the impact of accelerated depreciation and the fact that the tax system does not tax the appreciating value of a project during the construction period (EPAC 1995a).

A range of criticisms has also been levelled at the offset scheme. Specifically, Green (1998) argued that, compared to the former infrastructure borrowings program, the new scheme is worse in a number of respects — the type of projects considered is narrow, the guidelines appear to be subjective, eligibility is less certain and there is no avenue to appeal decisions. Submissions to the Rail Projects Taskforce (1999) criticised the limited funding for the scheme which is capped at \$75 million a year. The Taskforce noted that the scheme favours well-developed

projects that are near financial close and commencement of construction rather than projects still in the development phase.

There are doubts about the effectiveness of the Infrastructure Borrowings Tax Offset Scheme in the context of the rail sector. In general, the scheme appears to assist projects that would have proceeded anyway.

Section 51 AD

Section 51AD of the *Income Tax Assessment Act 1997* (Cwlth) was originally introduced to prevent ‘sale and lease back’ arrangements between State Governments and the private sector. Under these schemes, a (tax exempt) government body would sell infrastructure assets to a private entity which would then lease the assets back to the government body. In this way, the private entity could claim tax deductions on depreciation and interest expenses while the government body retained effective control over the infrastructure. As noted by the ARTC, such arrangements were ‘at the expense of the Commonwealth tax revenue’ (trans., p. 807). Section 51AD disallows these tax deductions, reducing the attractiveness of sale and lease back schemes.

A number of participants (including Australasian Railway Association, ARTC, NSW Government, Queensland Transport, QR and Victorian Government) expressed concerns about s.51AD. QR argued that it is a significant impediment to private sector investment in rail infrastructure:

... this Section makes it difficult (if not unprofitable) for the private sector to directly finance and own a major railway deviation. The effect for private sector rail infrastructure owners is their costs may not be deductible if the railway operators using that infrastructure are tax exempt bodies and are deemed to control the use of the railway. (sub. 59, attach. 2, pp. 22-23)

The NSW Government contended that the discretionary powers under s.51AD introduce a level of uncertainty for State Governments that disadvantages BOOT-type projects:

Given the level of State Government financial support for the rail industry, the private sector would generally fail the ATO’s ‘control’ test when applied to BOOT projects. In fact, ATO clearance of the BOOT component of the New Southern Railway project came only after lengthy negotiations over the amount of ‘control’ exerted by the State Government in the contract arrangements with the private sector developer. (sub. DR128, pp. 42-43)

The Private Infrastructure Task Force (EPAC 1995a) concluded that there was little justification for retaining the anti-avoidance tax provisions (s.51AD and Division 16D) in their present form due to intrinsic deficiencies. Structuring private

projects to avoid the provisions was also found to be costly and time consuming. The Task Force recommended that the provisions either be abolished or redrafted. Its preference was to replace the existing provisions with new general leasing provisions.

Section 51AD and other business tax issues are being considered by the Review of Business Taxation (RBT 1999). The RBT noted that s.51AD and Division 16D are complex in their application of the effective control test, but the complexity of s.51AD is exacerbated by the severity of its application — it disallows deductions relating to assets completely while all income remains taxable. The provision has become more problematic with the privatisation and contracting of government activities that were not contemplated when it was first conceived (RBT 1999). The RBT will submit its final recommendations to the Commonwealth Government in August 1999.

The anti-avoidance provisions of the Income Tax Assessment Act (section 51AD and Division 16D) may act as impediments to private sector investment in rail infrastructure.