
12 The way ahead

12.1 The case for continued reform

Since 1991, the Commonwealth and States have to varying degrees, undertaken reforms aimed at improving their rail systems and regulatory regimes (chapter 3). Some progress has been made in increasing the commercial focus of railways, restructuring rail systems, increasing private sector involvement and reducing the complexity of safety legislation and operating procedures.

There is evidence that the reforms to date have improved railway performance. Newly privatised railways are becoming profitable and new entrants are competing in niche markets. Freight rates have reduced substantially. Productivity has increased overall and service quality has improved in some jurisdictions, especially New South Wales and Queensland.

However, in some markets, freight railways are still making losses or are barely viable. Productivity in Australia is still significantly lower than in North America, so freight rates are higher. Rail continues to lose market share to road in the transport of non-bulk freight.

Among government-owned railways, there is evidence of a lack of investment in some areas and the quality of infrastructure has declined. Yet many railways, both passengers and freight, continue to receive significant government financial support.

Some problems are more specific to particular networks, for instance black coal railways have been used to extract monopoly rents.

Structural reform and the introduction of access regimes have been proceeding slowly. There are problems associated with multiple access regimes and complex arrangements within individual regimes.

Inconsistent accreditation fees and operating procedures and standards are an impediment to efficient rail operations. Although progress has been made to reduce such inconsistencies, outcomes are uncertain.

Completing these reforms and removing regulatory barriers are expected to yield further improvements in performance.

12.2 Priorities for reform

The overall objective of reform is to have an efficient transport system — this involves having the appropriate mix of transport modes which best meet Australia's freight and passenger transport needs (chapter 5).

In order to ensure a place in the transport system of the future, railways must continue to improve their efficiency. To some extent, past reforms have yielded the 'easy' gains resulting from improving the efficiency of the existing rail systems. Future reforms need to be targeted to yield the more difficult efficiency gains resulting from the choice of technology in rail systems and the participation of rail in the transport logistics chain.

As noted in chapter 5, governments need to create an environment that will give rail the opportunity to take its place in an efficient transport system.

In many markets rail competes with other modes of transport. The ability of railways to compete in these markets can be impeded by a lack of commercial focus to drive efficient operations. This report has made a number of suggestions as to how to achieve an environment to enable railways to operate more commercially. These centre on addressing ownership and structural arrangements, ensuring competitive neutrality both within the rail sector and between transport modes, and removing complex and inconsistent regulatory arrangements, and introducing competition in railway operations.

Increasing commercial focus

To achieve a commercial focus, it is important that railways have:

- the flexibility to make timely decisions (both investment and operational);
- the ability to form strategic alliances, mergers or joint ventures;
- access to capital; and
- no undue restrictions on input choice.

There are a number of ways in which the commercial orientation, customer focus and market responsiveness of railways can be improved. One is the stricter application of the corporatisation model to government-owned railways. However, a threshold issue is whether the rail industry tests the limits of this model.

Competitive tendering and franchising, particularly in urban passenger networks, may offer benefits beyond those available from simply corporatising a government railway, largely because of the private sector's stronger commercial orientation.

Franchising may generate further gains compared with contracting out because franchisees usually bear some revenue risk which is likely to strengthen their incentives to develop the market.

In the case where there is strong competition from other transport modes, such as road, privatisation will be desirable. There is no reason why most freight operations should not be privatised. In cases where there is strong competition from road, track infrastructure could also be privatised, or at least subject to a long term lease arrangement. There is evidence that the initial privatisation of former government-owned railways has been successful — Tasrail has substantially improved its performance since being privatised.

Non-commercial services

Governments have, and will continue to have, important social and economic objectives relating to rail. The emphasis on increasing the commercial focus of railways does not preclude governments from using railways to achieve non-commercial objectives relating to urban passenger and other services.

The challenge is to implement an approach that allows both commercial and non-commercial objectives to be met without impeding the ability of railways to compete commercially, where possible, against other modes.

If governments choose to subsidise railways, they should clearly specify their policy objectives, the services required to achieve these objectives and the appropriate level and form of the subsidy to be provided.

Promoting competition

Not all railways face competition from road or other transport modes. But there are several forms of competition that may be generated within the rail sector to control any market power. Governments can use competition for the market, which occurs when operators compete to win a franchise or contract to provide a particular service for a given period. Train operators may also compete for the same customers, so called ‘rail-on-rail’ competition. There may also be competition for train schedules in the network — where train operators compete for the right to obtain the schedule they value most highly.

Promoting competitive neutrality

Arrangements ensuring competitive neutrality both between different modes and within the rail sector are required if competition is to result in an efficient transport system.

With regard to intermodal competition, each mode should be able to compete on the basis of price and service quality without being unfairly advantaged or disadvantaged as a result of government policy.

Planning and investment is one area where governments can directly affect competitive neutrality between modes. There are three broad options: an integrated approach involving a public organisation preparing a plan for both the national road and rail network; separate road and rail planning organisations along with subsidies to rail so that it is treated in a similar manner to roads (as in Sweden); or a more commercial approach to both rail and road transport. The Commission's preferred approach is to adopt the latter option, that is to introduce appropriate road investment, pricing and cost recovery arrangements, and allow both road and rail to operate on a commercial basis.

The issue of competitive neutrality within the rail sector also arises. It is possible that on some routes there will be a mix of government and privately owned train operators. No railway should be advantaged or disadvantaged simply as a result of its ownership — it should compete on its own merit.

Increasing the commercial focus of railways, and encouraging private sector operators, will address many of the concerns regarding competitive neutrality within the rail sector.

Introducing consistent regulatory arrangements

Inconsistent operating procedures and standards and variations in accreditation fees across jurisdictions are still impediments to efficient rail operations. Although progress has been made, the outcomes are uncertain. It is too early to ascertain whether operators' concerns regarding rail safety regulation more generally have been resolved, although it would appear that progress has been made in introducing consistent regulation and mutual recognition across states. Uncertainty also remains regarding operating procedures and standards because the codes of practice relating to these procedures have yet to be implemented.

There are processes in place to deal with inconsistencies in rail safety regulation and operating procedures and standards, but issues remain to be resolved.

12.3 Implementation strategy

Improving the performance and efficiency of Australian railways requires that both the Commonwealth Government and other Australian jurisdictions undertake reforms over which they have control and responsibility.

Some reforms require collaborative action by governments, while others can be undertaken by governments acting independently.

The Commonwealth Government's role

Given the need for a national approach on some reforms, it is appropriate that the Commonwealth adopts a significant role in leading the reform process.

The Commonwealth should have direct responsibility for a number of reform areas — the development of a national transport policy framework, ensuring competitive neutrality and facilitating a consistent approach to safety and operational regulation. Reform in these areas is required irrespective of the changes individual jurisdictions make to their own railway networks. In addition, the Commonwealth also has a role, in consultation with affected States, in establishing a single interstate network manager and in providing funds to alleviate major problems on this network.

Developing a national transport policy framework

The Commonwealth could play an important part in developing an overarching national transport policy framework. This framework would set out the Commonwealth's main objectives and directions for the national transport system regarding efficiency, safety, equity and the environment.

A national transport policy framework would differ — with less detail and no funding commitments — from the integrated strategic plan for the national transport network recommended by the HORSCCTMR (1997) and from the NSW cross-modal transport plan *Action for Transport 2010*.

Ensuring competitive neutrality

It is the responsibility of the Commonwealth to ensure that there is competitive neutrality between transport modes. The Commonwealth has already partly addressed a previous anomaly through recent reforms to the diesel fuel excise.

A key element of a national transport policy framework would be to facilitate competitive neutrality between road and rail, with both modes operating within a more commercial environment.

Reforms to the provision of roads are also required, including road transport planning processes, methods of investment appraisal, road funding, and charging for different classes of vehicles. The Commonwealth should establish an inquiry into road investment and provision in Australia.

Facilitating consistent safety regulation and operating procedures and standards

The Commonwealth should continue to facilitate the removal of regulatory impediments to interstate rail operations, particularly inconsistent safety accreditation fees and operating procedures and standards. This process should be undertaken in consultation with industry and the States and Territories.

Monitoring the progress of mutual recognition of rail safety accreditation processes is also required. If mutual recognition does not appear to be functioning effectively consideration should be given to alternative approaches, such as a single national safety regulator.

Facilitating the establishment of an interstate network manager

The Commonwealth should facilitate the establishment of a single manager for the interstate network. In the first instance the Commonwealth and the affected States should establish a process to develop the specific roles and responsibilities of the interstate network manager, and define the extent of the interstate network.

Access arrangements on the interstate network would be embedded in a code of conduct governing the operations of the interstate manager. The network manager would be responsible for setting the terms and conditions for access.

It would also be responsible for allocating train schedules and contributing to the identification of investment needs across the whole interstate network. Setting prices and allocating train schedules should reflect the opportunity cost of all users of the interstate network, both interstate and intrastate train operators. An option which the network manager may consider is the use of market-based mechanisms for determining train schedules, including capacity transfer arrangements and auctioning.

The network manager would be in a position to identify areas of possible investment in the interstate network. However, significant congestion problems in the Sydney metropolitan area which affect operators throughout the interstate network need to

be addressed immediately. The Commonwealth should — as a matter of national priority — provide funding to alleviate congestion on the interstate network in the Sydney metropolitan area, subject to acceptance of the network manager model.

The jurisdictions' role

Reform of structural, ownership and access arrangements is the responsibility of each jurisdiction, including the Commonwealth in regard to the interstate network. Railways can be separated into three categories to facilitate the application of policy reforms — interstate, regional and urban passenger networks. Regional networks can in turn be divided into those with market power (the main coal lines) and those without. This categorisation is not a rigid taxonomy but is intended to highlight the contrasts that exist in the Australian railway system and is a useful device for policy development. Railway networks are classified according to the dominant rail operation (freight or urban passenger); other train operators, such as those providing non-urban passenger services, would negotiate access to these other networks.

Interstate network

The preferred approach to the interstate network is to vertically separate the track from train operations, with a single horizontally integrated network manager to administer access and facilitate investment.

This package is intended to facilitate competition on the interstate network. Three aspects of competition could be enhanced — competition between railways and other transport modes, competition between train operators for the same customers, and competition for train schedules.

The Commonwealth and its joint shareholders should conclude the sale of the National Rail Corporation. This process has been under way for some time and an expeditious sale will assist in maintaining the momentum of reform.

Regional networks

Policy packages have been developed for regional networks without market power and those (the main coal lines) which are able to exercise market power.

Regional networks without market power

Regional networks should be horizontally separated from urban and other freight networks. They should also be vertically integrated. There is strong intermodal

competition, little scope for competition between train operators, and benefits accrue from combining train operations and track infrastructure.

Stringent application of the corporatisation process may facilitate the adoption of a more commercial focus. However, increased private sector involvement through franchising or privatisation is more likely to achieve greater benefits than those achievable through corporatisation. A number of privatisations have already taken place among these networks — in Victoria, Tasmania and South Australia.

Only light-handed access regimes are required. Given the low volumes of freight carried on most of these networks, there is unlikely to be much demand by other train operators for access. Where there is demand, the commercial approach of the railways, together with excess capacity, suggest that access would be negotiated between the parties.

It is expected that horizontal separation and increased private involvement will give these networks the freedom and commercial focus (including greater autonomy, flexibility and access to capital) required to compete with a strong road transport industry.

Regional networks with market power

Horizontal separation of regional networks with market power (the main coal lines centred around the Hunter Valley in NSW, Goonyella and Blackwater coal railways in Queensland) will facilitate the regulation of the natural monopoly element of the network. Horizontal separation also facilitates the franchising of these networks.

The Commission's preferred approach is for track and train operations to be vertically integrated. Market power in track infrastructure would be addressed through the promotion of competition for the market using franchising. Vertical integration permits the realisation of gains from the application of logistics management, including the optimisation of the transport process from the mine to the port.

Incentives to improve efficiency are generated by promoting competition for the market through contracting out or franchising, using competitive bidding. Other rail operators, apart from the incumbent, could enter the market from time to time. Provisions for access would be included in the franchise agreement.

This approach maximises the possibility of capturing the gains available from retaining an integrated system while also introducing pressures to minimise costs — at least during the bidding process.

Urban passenger networks

Urban passenger networks should be horizontally separated from freight networks but remain vertically integrated. Vertical separation of train operations from track provision is unlikely to generate benefits.

A purchaser-provider framework should be applied to the separated businesses. Government agencies, such as departments of transport, education and community services should be responsible for the planning, specification and purchase of services. They would be responsible for monitoring performance and ensuring that the provisions of the contract are met by the service provider.

The selection of the provider should be through a competitive process involving contracting out or franchising, thus introducing competition for the market. Larger urban networks could be horizontally separated further by geographic area, thereby facilitating ‘yardstick’ competition, as is expected to occur in Victoria.

There is no particular need for a strong access regime because there is little potential for competition between train operators for customers and train schedules.

It is expected that these reforms will lead to an improvement in the efficiency of transport in urban areas, particularly in the areas of planning, provision and pricing of rail services.

Implications for individual jurisdictions

The priorities for reform have different implications in each jurisdiction because of differences in the characteristics of their railways. Progress in reform has varied between jurisdictions, but the potential exists for further change in them all.

The reform packages have the greatest implications for Queensland. Currently a single, vertically integrated, government-owned railway, it has regional (including coal) freight networks, an urban passenger network and provides non-urban passenger services. The Queensland Government should consider whether its rail system would benefit from reforms to its structure and/or ownership arrangements. In the first instance, it could separate, and franchise, its two major coal hauling railways (centred on the Goonyella and Blackwater regions) from the rest of the network. In the next stage it should consider horizontally separating (and franchising) its urban network from the remainder of the network and also privatising Queensland Rail’s remaining freight operations.

New South Wales could also adopt a similar approach for its Hunter Valley coal freight railways to ensure that progress in improving their performance continues.

The privatisation of FreightCorp should also be investigated and the payment of subsidies for track infrastructure reconsidered. If subsidies are to continue, the payments could be better focused and minimised through their inclusion in franchise agreements with operators, or negotiated as part of the privatisation of regional railways.

Further reform of the interstate network has particular implications for the Commonwealth, New South Wales, and Western Australian Governments. They are currently owners of parts of the network, have separate access regimes, and own railways which operate over parts of the network. The single network manager approach will be more effective if the interstate network is vertically separated. This implies that the proposed sale of Westrail exclude the track between Perth and Kalgoorlie. Promoting competition over the entire interstate network through a single network manager is likely to generate significant benefits and give rail an opportunity to strengthen its competitive position on these important transport corridors. Such an approach will require cooperation between these jurisdictions as operators and owners of the network.

In most jurisdictions the performance of urban passenger rail systems could be improved by a more rigorous application of the purchaser-provider framework and by introducing competition for the right to provide these services. Evidence from Victoria, South Australia and Western Australia demonstrates that urban networks can be horizontally separated successfully from the remainder of the rail network. Victoria's initiative in franchising its urban railways should be monitored with a view to applying the model in other jurisdictions.

12.4 The impact of reforms

At the broadest level, these reforms will lead to a more efficient transport system.

More specifically, their implementation would be expected to improve the environment within which railways operate by:

- creating more commercially-focused railways, with the flexibility to make operational and investment decisions in a timely manner; and
- reducing uncertainty, particularly relating to competitive neutrality, regulatory arrangements and the role of government more generally.

This in turn could encourage greater private sector interest in entering the Australian market, through contracting out, franchising, the privatisation of existing government-owned railways, or the formation of new companies. Private operators would have strong incentives to minimise costs, thus leading to further improvements in rail performance.

They would also have greater incentives to undertake new investment wherever it is viable and adopt more innovative approaches to investment. Tranz Rail in New Zealand has adopted an approach of reconditioning second-hand locomotives rather than buying new equipment — thereby greatly reducing the cost of supplementing its locomotive fleet. Private operators are also better able to raise the required capital, free of government borrowing constraints.

It is expected also that the reforms would result in further market segmentation, especially on the interstate network, and the development of specialist operators to meet specific customer requirements. There are examples of this occurring already on the interstate network as a result of previous reforms.

The approach to reform suggested by the Commission may also affect railway employment, especially in government-owned railways, although less so than in the past in most jurisdictions.

However, new private participants, such as Specialized Container Transport, Toll Rail and Patrick have already entered the market. Further private participation in the industry has the potential to stabilise employment or at least slow the rate of decline.

Secure employment in the rail industry can best be promoted by an efficient industry that is better able to compete with alternative forms of transport, especially road transport, and whose dependence on government subsidies is minimised.

In addition to industry wide changes in employment, there may also be region-specific issues associated with employment losses or the reduction or cessation of services. These issues are being considered in the Commission's concurrent inquiry into the impact of competition policy reforms on rural and regional Australia.

If the reform of railways is not pursued the industry may not survive long into the 21st Century, other than as a carrier of coal and other bulk products. Further reform of the Australian railway industry will yield significant benefits to consumers of rail services. Rail services are an important input into many industries, especially the export-oriented mineral sector. Reductions in freight costs and passenger fares, and improved service quality will result in significant benefits, not only to passengers and Australian industry, but for the community more widely.