VICTORIAN GOVERNMENT SUBMISSION

TO THE PRODUCTIVITY COMMISSION'S INQUIRY INTO PROGRESS IN RAIL REFORM

RESPONSE TO THE DRAFT REPORT

May 1999

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Key messages from the Victorian Government submission

- Rail is an important cog in the Australian economy, but it should be an essential one. The lack of a efficient rail industry across the board puts Australia at a competitive disadvantage

- Victoria is a long way down the track in terms of reform - our privatisation program is as recommended by the Commission. The Commonwealth and other states must follow suit in order to improve the efficiency of rail across Australia. Increased private sector involvement is the key element in reform.

- Without increased private sector participation and greater levels of competition, the historical and institutional mindset that pervades much of the Australia's rail culture will continue. The changes implemented in Victoria will deliver independent, commercially driven businesses operating within a transparent regulatory and contractual framework.

- The Commonwealth needs to spend more money on targeted rail track investment and encourage greater private sector involvement. When making funding decisions the Commonwealth should focus on those routes best suited to increasing intercity capacity.

- Progress on harmonising rail standards between the different states has been slow. This makes it harder for rail service providers to operate and compete interstate. This reduces the competitiveness of rail freight versus road and harms the Australian economy.

- Subsidies provided to publicly run rail operators should be explicit and transparent. Competition should not be based on cross subsidies. Following the Victorian program of privatisation subsidies for track and freight will virtually disappear.

- The Victorian Government recommends that all interstate rail services across Australia be subject to open and fair competition. Operators competing on this network should be placed in the hands of the private sector.

- It has been proposed that a public rail organisation, such as Freightcorp, be eligible to purchase National Rail. Victoria is opposed to any such purchase. Such a purchase would perpetuate much of the institutional and cultural inertia that pervades many public rail organisations in Australia, manifested in behaviour such as competition through cross subsidies and lack of commercial focus.

- The Victorian Government supports the Commission's proposal that it do an inquiry into the provision, funding and pricing of roads in Australia.

1 Introduction

The Victorian Government welcomes the opportunity to respond to the Productivity Commission's Draft Report into *Progress in Rail Reform.*

In general, the Victorian Government is in agreement with the key messages contained in the report. The reform of the Victorian rail industry, as endorsed by the Commission, will be completed before the Commission's final report is released. However, there are several issues in which the Victorian Government would like to comment on. These are outlined below, and follow the structure of the draft report.

2 Key reforms

2.1 The big picture

Rail is an *important* cog in the Australian economy, but it **should be an essential** one.
It is important for the rail industry to operate as efficiently as possible to provide a credible alternative to road and air transport. This is particularly true in areas such as long haul non-bulk freight (for example, between the Eastern states and Perth) where rail should have a natural advantage, but road and air transport are increasingly gaining market share.

While road and air transport provide better service, they are often more expensive alternatives and the lack of a efficient rail industry across the board puts Australia at a competitive disadvantage. Freight rates within Australia are much higher than those in North America.

Without increased private sector participation and greater levels of competition, the historical and institutional mindset that pervades much of Australia's rail culture will continue. Parts of this system are:

> Inefficient compared with road and air transport.

> Captive to its own history, institutional and regulatory systems rather than contemporary economic forces.

> Burdened by excessive government involvement in every element of the system, manifested by unclear community service obligations (CS0s), under capitalisation, distorted pricing signals, and poor regulations and institutional practices.

The reforms undertaken in Victoria since 1993, and most importantly the privatisation currently under way, will help dismantle this historical baggage and improve transport delivery across the state, as well as movement within Metropolitan Melbourne. It is up to the Commonwealth and other states to follow suit.

2.2 Fast tracking reforms

The draft report supports the Victorian privatisation program and favours increasing the commercial focus of rail. While the Commission recommends a 'horses for courses' policy in terms of reform, Victoria believes that the introduction of competition wherever possible will secure the largest gains in terms of efficiency.
The Commission proposes a range of reforms across a spectrum ranging from increased contracting out and corporatisation to franchising and privatisation. While Victoria agrees that different mixes of horizontal and vertical separation should be put in place depending on the nature of the market, greater private sector involvement is the key element in reform. Overall the Commission undersells the benefits of increased private involvement and the introduction of competition by looking at options such as corporatisation.

As outlined in the first Victorian submission, the best way to increase the commercial focus of rail is put it in the hands of the private sector - these points are expanded on later in the submission.

2.3 Further progress in reform

The sale of V/Line Freight was completed on 30 April 1999. The new owner, Freight Victoria, has announced plans to investigate the extension and improvement of services, as well as investing in rolling stock and infrastructure upgrades.

The franchising of passenger businesses to private operators should be completed in the third quarter of this year. This will lead to improved services, new rolling stock and reduced subsidies.

3 Performance and rail productivity

The Victorian Government agrees with the Commission that there has been significant improvements in rail productivity since the early 1990s. However, the Commission's use of the data envelopment method for calculating productivity may not reflect the real story of reform in Victoria (reported to be 'low' at 4 per cent a year from 1989-90 to 1996-97 in the draft report - p. XXIII).

The calculation of productive efficiency used in the analysis is to multiply scale efficiency by technical efficiency. Scale and technical measures should be reported separately, on top of the overall measure to give a more complete picture.

Victoria compares favourably in terms of technical efficiency with the highest rate of growth of 8 per cent a year - which reflects the returns to reform undertaken during this period. This is perhaps a better measure of relative changes in productivity given Australia does not have the scale economies of the United States (as outlined in the Commission's productivity seminar).

In terms of scale efficiency according to the analysis Victoria performs relatively poorly, with productivity decreasing by 3 per cent each year. The Commission attributes this to:

> .... the relatively low estimated scale efficiency of its freight services over the period of the study. PTC's scale efficiency had a negative growth rate, indicating that the transfer of interstate freight to AN-NRC strongly disadvantaged PTC's scale of operations. (p. 15)

Given:

> In the analysis productivity is based on the inputs used in the production of one unit of rail output, and

> track is the most substantial input in the production of a rail output.... how did the Commission treat the Victorian track used by AN-NRC for the carriage of interstate freight after 1994-95?

It would seem to make sense to pro-rata the Victorian track input to the AN-NRC if they were utilising it to produce rail output, even though the PTC at that stage was responsible for running track within Victorian borders.

The treatment of relative efficiency of rail operations in different states is also misleading in that not enough weight is given to inherently different nature of the tasks performed. More specifically a correct analysis would allow:

> For the preponderance of coal in the figures for freight in NSW and Queensland, and

> Would allow for different network sizes and journey times when making passenger comparisons.

4 Impediments to improved performance

The Commission highlights that although performance has improved, impediments still remain. The Victorian Government has perhaps a less rosy outlook, and believes that across Australia there are still significant obstacles to improved performance -particularly in terms of the investment and regulatory framework in which rail operates.

4.1 Investment and commercial focus

Across Australia, potential rail investors face an industry which is characterised by the problems highlighted in the draft report, including:

> Inadequate investment where it is needed (that is, it should be directed by market forces and not driven by supply), and

> Lack of commercial discipline.

These issues must be tackled jointly by the states and the Commonwealth.

The reforms undertaken in Victoria are addressing these concerns. The changes will deliver independent, commercially driven businesses operating within a transparent regulatory and contractual framework.

The new program will increase the commercial discipline of the operators through incentives for increasing patronage, performance targets (as well as penalties for nondelivery) and innovation. Further service enhancements and investments are being driven by the competitive bidding process.

Put simply, the Commonwealth needs to spend more money on targeted rail track investment and encourage greater private sector involvement.

4.2 Safety

Progress on harmonising rail safety standards between the different states has been slow.

This makes it harder for rail service providers to operate and compete interstate and this reduces the competitiveness of rail freight versus road. The Victorian Government agrees that a single annual fee for accreditation should be payable only in the jurisdiction of principle activity. Accreditation and mutual recognition should also be consistent across all states.

The Commonwealth should give priority to harmonising rail standards between states, as will Victoria through avenues such as the Standing Committee on Transport (SCOT). The Victorian Government also suggests that the Commission develop more concrete proposals for speeding up the harmonisation of rail standards.

4.3 Access and auctioning train paths

In the draft report the Commission suggests auctioning train paths as a means of pricing and allocating schedules to reflect the value users place on the track.

However, users will only place value on the track when capacity is scarce. The possibilities also differ between urban and non-urban networks.

The concept appears to be based on the Commission’s work on airports. However, the two sectors are not strictly the same. At busy airports, landing slots are scarce and the cost of providing more slots by adding new runways or opening new airports is large. In rail networks, especially the intestate freight networks to which the Commission is referring, the cost of dealing with capacity bottlenecks is much lower. The Victorian network is not expected to experience such capacity constraints, with the exception of a few places on one interstate route. These difficulties could be overcome relatively cheaply by installing passing loops.

On urban lines, which may face capacity or expansion constraints in places, the issue is different. Although some competition on the Metropolitan rail network may be feasible, third party competitors will not receive the subsidies paid to the successful franchise bidders and schedules are set out in the franchising agreements. Therefore substantial third party competition is unlikely in the short-term given the relative costs, and the scarcity of new train paths in peak periods.

5 Is competition the answer?

In short, the answer is yes.

As mentioned earlier, options such as corporatisation put forward by the Commission will not go far enough in reforming the poorly performing parts of the Australian rail industry.
As the draft report discusses, corporatised rail entities suffer from:

> Poor customer focus and market responsiveness, as well as inadequate funds for investment or the capacity to borrow on their own behalf.

Multiple and often conflicting non-commercial objectives.

> Governments that are unable to stay at arm's length from corporatised railway boards because of political and community pressures.

The Victorian model for franchising rail services will overcome these difficulties - as outlined in the Victorian Government's first submission.

The discussion on corporatisation in the draft report misses the fundamental reason for the need for private ownership - 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.

5.1 Sale of NR

In its initial submission Victoria supported the sale of National Rail.

It was hoped that the benefits of competition and the discipline of the market mentioned above would lead to a more efficient organisation serving the Australian rail market.

However, since the draft report it has been proposed that a public rail organisation, such as Freightcorp, be eligible to purchase National Rail.

Victoria is opposed to any such purchase. Such a purchase would perpetuate much of the institutional and cultural inertia that pervades many public rail organisations in Australia.

5.2 The UK experience

The United Kingdom has had a varied, but mainly positive experience with the privatisation of its rail network. Many of the reported problems are the problems of success as a consequence of large rises in patronage.

The Victorian Government has studied the lessons from the UK - the good and the bad - and has developed a franchising and leasing model of its own, tailored specifically to the needs of Victoria.

In the Victorian model the companies running the trains (and trams) will control the assets on which their operations depend - that is, they will own their own rolling stock and be accountable for maintaining and renewing the track and signalling. In the UK third parties control the network and own the vehicles. Victoria also has better arrangements for through ticketing and passenger information, on top of stiffer penalties for poor performance.

Below is a summary of the results of rail privatisation in the UK.

Assessment of rail privatisation in the UK

Although the UK rail privatisation initiatives have attracted criticism, there are many positive points that are often missed.

Patronage and service

- Patronage is rising at 7% a year, and the Association of Train Operating Companies expects it to grow at 10%. Passenger rail travel is at its highest level since 1947, and post-privatisation operators are running 1,000 more services a day than before privatisation.

- Operators are committed to investing $40 billion over the next five years to improve the network. 1,700 new vehicles have been added on the order books of stock manufacturers since franchising was complete.

- Increases in rolling stock and track upgrading is being achieved while subsidies are failing. Over the first seven years of the UK franchises, taxpayer funding is set to fall by 60%, largely because of improved marketing and increased patronage.

- Complaints have risen in the UK, not least because operators have actively encouraged customers to tell them when service does not come up to scratch. High patronage growth has contributed to overcrowding, while the provision of extra services has partly helped reduce punctuality.

- Of the 25 train operating companies in the UK, about 65% of complaints relate to just four companies, all of them serving intercity routes which had suffered from particular under investment since the 1970s.

Fares

- For years under private ownership, fares rose at 2.5% in real terms each year, which is why UK fares have historically been the highest in Europe. This year fares have actually come down by 1.1% in real terms, partly because of government regulation, and partly because operators have introduced new discount fares.

Freight

- After years of decline, rail freight has turned the corner since privatisation. The UK's new rail freight operator EWS (owned by Wisconsin Central Railroad) has set itself the goal of trebling the volume of freight on rail within ten years, and is spending $1.2 billion on 280 new locomotives and 4000 new wagons to meet this objective.

- Rail freight grew at 16% in the second half of 1998 and new freight terminals have been opening at the rate of 20 a year.

Subsidy levels

- Subsidies in 1994-95 and 1995-96, when the railways were in public ownership, stood at $5.2 billion. In 1997-98, the first full year of privatisation, the equivalent figure was $4.9 billion. In addition the UK taxpayer secured proceeds of $13 billion from the sale of Railtrack and the other former BR companies.

- Those companies are now paying tax to the Government of some $300 million a year, and the Government subsidy is set to fall by 60% over the first seven years of the passenger franchises.

Source: International Railway Journal November 1998, and various sources including (UK) Railway Industry Association, and (UK) Association of Rail Operating Companies.

6 Competitive neutrality

6.1 Rail versus rail

In its initial submission the Victorian Government asked the Commission to investigate whether or not interstate providers have an unfair advantage through government support, and what measures could be taken to address this.

The Commission found:

> Reforms under corporatisation have the potential to place government-owned railways on a commercial footing, but in practice they appear to be insufficient f
> to achieve competitive neutrality in the rail transport market. (p.192)

... and...

> Although not required by the Competition Principles Agreement, private sector provision of rail services - whether through contracting out, franchising or privatisation - is a more effective means of aligning commercial practices between competing rail operators. (p. 192)

These findings support the Victorian position that the operation of rail services is best left to the private sector. Subsidies provided to these operators should be explicit and transparent to avoid propping competition through vaguely defined CS0s and crosssubsidies.

As outlined in the draft report NSW railways receive total subsidies of around $1.1 billion, while Victoria rail operators were paid about $380 million. In the near future, once services are franchised, subsidies paid to Victorian rail operators will decrease even further. Subsidies for track and freight will almost disappear.

The Victorian Government recommends that all interstate rail services across Australia be subject to open and fair competition. Operators competing on this network should be placed in the hands of the private sector.

6.2 Road versus rail

Road and rail users should each pay appropriate charges for the use of infrastructure including contribution towards external costs.

From an overall perspective road pays its way and rail does not. However, it is possible heavy trucks may not pay enough for road use, cars and light trucks may pay too much. The possible introduction of the GST and any associated reductions in the price of diesel fuel will also have an impact.

The Victorian Government supports the Commission's proposal that it do an inquiry into the provision, funding and pricing of roads in Australia (p. 217). This should be broadened to cover competitive neutrality between road and rail. This inquiry would address many of the misconceptions about the relative funding and charging of road and rail.

7 Conclusion

The Victorian Government sees the reforms currently underway in this State as a very positive step forward for the rail industry within Victoria. However, the lack of progress in other states is hampering rail’s progress and development across Australia.

Although the Victorian approach is implicitly endorsed in the draft report, other options put forward by the Commission, such as corporatisation, will not go far enough in driving reform and producing a more efficient and competitively focussed rail industry. The Victorian Government urges the Commission to highlight and explicitly endorse the benefits of the Victorian approach. Such an approach will improve the rail industry across Australia and increase its vitality and efficiency, as well as providing increased competition for road and air transport.

The Victorian Government also suggests the Commission:

> Repackage and recalculate its productivity measures as outlined in Section 3 -Performance and rail productivity.

> Highlight areas in which the Commonwealth should be better targeting interstate rail investment.

> Develop more concrete proposals for advancing rail safety harmonisation.

> Oppose the sale of National Rail to a public (or semi-public) organisation.

> Conduct an inquiry into the funding and pricing of roads in Australia, and competitive neutrality between road and rail.