RAIL ACCESS CORPORATION

RESPONSE TO PRODUCTIVITY COMMISSION'S DRAFT REPORT "PROGRESS IN RAIL REFORM"

This submission represents the views of the Rail Access Corporation which are not necessarily those of the New South Wales Government

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EXECUTIVE SUMMARY

Introduction

Rail Access Corporation (RAC or the Corporation) welcomes the opportunity provided by the Productivity Commission (the Commission) to comment on its draft Report, “Progress in Rail Reform” (the Report).

The Corporation acknowledges that this is the first submission that it has made to the Commission. As a result we recognise that many of the comments and findings in the Report reflect the difficulties the Commission experienced in building a complete picture of the Australian rail industry, especially post-reform, as it was unable to access relevant data or did not receive key submissions.

We hope through this submission to rectify the Commission’s disadvantage and to provide it with a clearer understanding of the achievements resulting from rail reform in NSW.

Industry Structure

RAC believes that:

- There should be a presumption in favour of vertical separation, with the onus being on those who support vertical integration to prove the superiority of such an approach.
- There should be a presumption in favour of horizontal integration of track ownership.
- The market should determine whether above rail operations are horizontally integrated or not.

RAC’s view adopts as its starting point the strong case for vertical separation made out in Chapter 7 of the Report and places the onus on those who prefer integration to make the case for an integrationist approach. Of the arguments set out in the Report RAC believes that no convincing case has been made for integration.

RAC endorses the view that jurisdictional boundaries, such as those currently existing at State borders, represent a significant impediment to efficient operations. Horizontal integration of infrastructure which minimises such boundaries, should therefore be the preferred approach.

RAC is currently pursuing horizontal integration of interstate lines through a resale agreement with the Australian Rail Track Corporation (ARTC). It has been suggested that ARTC should control the track sections predominantly used for interstate business. However the geography and traffic patterns on the NSW network mean that any such transfer of track would create additional jurisdictional boundaries. This would also impede intrastate and commuter traffic.

The other issue to be considered is ensuring minimum complexity and cost of access for rail operators on the interstate rail market. If sections of the track were transferred to the ARTC then in NSW, where there is no separation of interstate and intrastate lines, rail operators seeking to operate on interstate lines would have to deal with both ARTC and RAC on this issue. This would be more complex than what currently exists and would increase administrative costs for operators.

RAC proposes a retail resale model with the ARTC providing a ‘one-stop shop’ for seamless and cost effective access to the interstate network for all rail operators.

Vertical separation and horizontal integration of track ownership are complementary strategies. When combined they allow market forces to determine the most appropriate level of horizontal integration above rail. RAC believes that where a mixture of vertically integrated and separated businesses occurs there is a significant potential for efficiency distortions to occur.

Performance Issues

RAC believes that the evidence from the vertically separated paradigm in NSW which has existed since July 1996 demonstrates that industry performance can be improved dramatically compared to the past vertically integrated industry structure.

Competition has boomed in the three years since the restructuring of the NSW rail industry on the vertically separated interstate network. In contrast, there is no evidence of meaningful competition or competition-driven economic benefits on those parts of the Australian rail network that remain vertically integrated.

Under the vertically separated model unprecedented cost reductions achieved for all industry stakeholders have positioned the NSW rail industry to be competitive and allowed it to generate new business growth to a level that has not been enjoyed by rail for decades. The NSW Rail Access Regime has also provided certainty and transparency to rail operators and prevented cross-subsidies. Cross-subsidisation is a common problem under vertically integrated models.

An assessment of pre and post reform structural models on a State by State basis, based on up to date and relevant data, would test the Report’s hypotheses regarding structural paradigms. Data on key performance areas such as operating costs, service standards and infrastructure performance in the areas of safety, and reliability are most relevant.

The use of US and Canadian rail benchmarks for the Australian system is sub-optimal, given the vastly different scales and characteristics of each of these marketplaces. International benchmarking should be based on similar, not disparate markets.

Regulatory Issues

RAC acknowledges that there is some duplication of safety regulation and operating standards. However many of the efficiency issues raised are a legacy of the pre-reform vertically integrated era in which responsibility for safety on the rail network was blurred and lacked any outcome orientation.

As RAC's track record demonstrates, the vertically separated and corporatised model provides a powerful commercial incentive for resolving efficiency issues. RAC's own commercial interests coincide with maintaining a high level of safety on the network while ensuring that costs associated with this are not a burden to existing operators or a barrier to potential entrants. In light of this imperative RAC is confident that, subject to the co-operative will of other jurisdictions it will be able to resolve efficiency issues affecting the provision of a safe network.

RAC supports the proposed Land Transport Commission playing a key role in managing non-prescriptive, non-mandatory Codes of Practice for safety operating standards. The Report's recommendation that the Commonwealth Government should take a leadership role in advancing regulatory reform is also supported.

Competitive Neutrality

The optimal solution for competitive neutrality is clearly for commercial and legislative equity to be established between road and rail. However RAC doubts that this is likely to occur in the short or medium term. We therefore support authority being given to a proposed Land Transport Commission to mitigate any inequities which disadvantage rail.

This argument is based on the evident failure of markets to achieve appropriate modal share outcomes given the imbalance created through taxation and institutional arrangements. Market failure is an economic policy issue, and is generally accepted as a trigger for Government intervention. In this case the establishment of a Land Transport Commission with economic planning capacity would be an effective instrument for intervention.

Social Issues

RAC acknowledges the importance of rail to regional Australia. We support the Report's view that any discussion of the issue, particularly concerning job impacts, should take into account other economic and social developments which also affect regional well-being.

In NSW post reform job losses have been as a result of specific efficiency objectives and are not in dangerous free-fall as they were pre-reform. This is an important distinction between the pre and post reform eras that bodes well for the long term welfare of the industry.

RAC recognises however, that labour market changes need to be managed to mitigate any negative social outcomes. Key players in the rail industry with responsibility for productivity outcomes should lead this process. Higher productivity based on effective management of labour needs is the optimal long term solution for job stability and growth and the commercial success of the industry as a whole.

Structure of RAC's Submission

This submission follows the structure of the Report, commenting in turn on the substantive chapters.

The submission has attached appendices. Appendix 1 is a detailed response to criticisms of RAC made by the NSW Mineral's Council in its submission to the Commission. Appendix 2 sets out background information about RAC and the environment in which it operates. Appendix 3 is a map indicating the multiple operator use of the NSW network. Appendix 4 contains an article from the International Railway Journal "The Need to Serve the Customer is Universal" by W.C. Vantuono on effective industry structure. Appendix 5 is a copy of a speech recently given by RAC Chairman, Mr Rod Sims to the Centre for Economic Development Australia, on the application of competition policy to the rail industry in NSW.

Conclusion

RAC has focused its efforts towards providing the Commission with a better factual understanding of pre and post reform structural impacts in NSW. We urge the Commission to review its findings in light of our submission. We would also urge the Commission to recognise in its final recommendations the distinct characteristics of the rail markets in Australia and the specific solutions needed for each market.

In this light RAC looks forward to receiving the Commission's final report that recognises the benefits of rail reform in NSW and the suitability of the vertically separated model to the NSW rail industry.

1.0: RAILWAYS IN AUSTRALIA A (REPORT'S CHAPTER 2)

1.1 Overview

Productivity Commission Report

Chapter 2 – Railways in Australia

RAC believes that the most important biggest single issue that the Commission needs to consider is the question of optimal structures for the rail industry. Section 2.2 of the Report provides important building blocks for itsthe later analysis of this issue and the Corporation is therefore concerned that this Ssection of the Report:

- contains a number of factual errors of fact;, and
- is structured around a categorisation approach that overly generalises, thereby losing important detail is fundamentally flawed.

RAC's Response

1.2 Factual Errors

RAC believes that table The errors of fact appear in table 2.6 of the Report contains factual errors whichand are later repeated in the Report. In NSW in the text.there has been competition: Contrary to the statements in the Report:

- There has been extensive competition "for the market" in the high-volume Hunter Valley coal business;.
- tThere has been extensive competition "for the market" on low volume regional lines in NSW;.
- There is competition between train operators (Freight Corp and Austrac) on the Riverina to Sydney and Riverina to Melbourne corridors, competition which is based around low volume regional lines; and.
- There has been competition ""for the market" on the interstate network in regard to the BHP billet / slab traffic.

1.3 Categorisation

The fundamental shortcoming of the categorisation approach used in the Report is that important detail is lost in attempting to generalise across market types. For instance, it is meaningless to say that high volume regional networks are "mostly" physically independent. The Pilbara lines are, while the NSW and Queensland networks are not. The same applies to urban passenger networks.

Similarly, it is impossible to generalise on the subject of intermodal competition. There are some traffics on low volume regional lines, particularly minerals and to a lesser extent grain, that are not subject to significant intermodal competition. Conversely, there are some coal traffics in NSW that are contestable between road, rail and sea.

Perhaps most importantly, there are appears to be considerable differences in the extent of competition that has taken place under vertical separation as opposed toagainst integration. The categorisation approach taken by the Commission masks these important differences by attempting to generalise across market types without regard to structure.

RAC believes that the flawed categorisation approach and the errors of fact have contributed to the Commission drawing inappropriate conclusions from its analysis of market structures in Chapter 5 of the Report. As discussed in more detail in subsequent sections of this submission, RAC believes that the Commission the Report should have a greater focus needs to focus more closely on the performance of different institutional structures is needed in order to to be able to draw meaningful conclusions on the issue of vertical separation versuss integration . Similarly, the Commissionit needs to focus more closely on the actuality of overlap between markets in order to provide meaningful analysis of the capacity for effectiveness of horizontal separation versuss integration.

2.0: THE PERFORMANCE OF RAIL (REPORT CHAPTER 4)

CHAPTER 4 – THE PERFORMANCE OF RAIL

Overview

2.1 2.1 Overview

In order to effectively measure the

The post- reform performance of the rail industrysince reform since reform has not been measured veffectively in the Report. Valid comparative models must be used.. The models shouldse should include an analysis of the following:

- *the nexus between industry structure and performance; and*
- comparable market segments and comparable rail systems.;

Issues for Effective Performance Measurement

An analysis of outcomes stemming from structural reform should have been undertaken as industry structure is inextricably linked to industry performance. Industry structure establishes agency accountabilities and incentives whichand in turn drives performance. The nexus between structure and performance can be seen in the comparative performance of infrastructure management in pre and post rail reform in NSW.

2.2 Structural Reform of NSW Rail Industry

Structural Reform of NSW Rail Industry

In July 1996 the rail industry in NSW was restructured to establish three State owned corporations out of the old vertically integrated State Rail Authority (SRA). RAC was given ownership and responsibility for maintenance of essential rail infrastructure; FreightCorp was given responsibility for operating the rail freight business and, Rail Services Australia (RSA) was given responsibility for infrastructure maintenance.

FreightCorp and RSA were no longer to have monopoly rights but were to compete for their work against potential new entrants. However in July 1998 the NSW Government placed a one year moratorium on the contestability program for maintenance work. This was to allow RSA time to implement the necessary structures to enable it to compete on an even footing with the private sector. The moratorium coincided with RSA's corporatisation on 1 July 1998.

Superior capacity of vertically separated model to generate competition

2.2 Superior Capacity of Vertically Separated Model to Generate Competition

The vertically separated model, must be given credit for enhancing productivity in the NSW rail market. The distinct accountability of RAC's capacity to drive establish the competition agenda and provide equitable, independent access to the rail market , cannotcould not be achieved through a vertically integrated model because of the characteristics of the NSW rail market. For example in the Hunter In NSW there are several end-users in profitable market segments such as the Hunter Valley coal chain there are several end users whose viability within a competitive market is considerably enhancedconsiderably enhanced by equity of access to rail at competitive rates.

Under a vertically integrated model, in NSW an incumbent owner-operator could have stifled such access by unfairly leveraging its infrastructure ownership as a barrier to entry. Access charges could be set at an oppressive rate for competitors, and restrictions on conditions of access could be set; any or all of these factors would effectively stifle competition in market segments.

In NSW the benefits of vertical separation in engendering new business growth have been real and significant . Since RAC's establishment approximately 62% of freight on a gross tonne kilometre basis, has been subject to competition between operators. In the central Hunter Valley for example, FreightCorp has reported (in its 1997/98 Annual Report) that coal producers paid 25% less in average rail freight rates in 1997/98 compared to two years before and estimates that in 1997/98 Hunter Valley coal producers saved in excess of $40m in freight rates.

Since the vertical separation of the NSW rail industry Tthere have been several new freight operators entering the NSW network. These include new freight operators such as Austrac, Specialised Container Transport (SCT), Northern Rivers Railroad and GrainCorp.

If the Commission wishes to provide credible commentary on the relative success of different structural models Iit is essential that an appropriate indicator of above rail competition be developed and measured if the Commission wishes to provide credible commentary on the relative success of different structural models.

Issues for Effective Performance Measurement

Effective performance measurement should have been based on:

- vValid comparative international models;
- vValid comparative market analysis and valid comparative rail systems in Australia; and
- tAppropriate data collection period and the identificationselection of appropriate categories of data and appropriate data collection.;

Valid Comparative International Models

2.3 Valid Comparative International Models

Valid international models must be chosen in order to meaningfully assess Australia's performance in the international marketplace. In this context, the Report's use of Data Envelope Analysis (DEA) to compareing the US and Canadian rail systems to the Australian rail system iwas flawed due to the lack of comparability. There is such disparity in the scale of the United .States. and Canadian rail markets in comparison to those of Australia is so disparate that it undermines the validity of the Report's findings on Australia's place in terms of world's best practice.

RAC notes that at the April workshop held by the Commission's April 1999 workshop on performance measurement (the workshop) the use of U.S and Canadian rail system comparatorss wasere acknowledged as being problematic by the authors of the Report and by its advisory ing experts. RAC understands that the Commission's final report will include international rail models which are more closely matched to the Australian market.

Markets selected for comparison should match the Australian market not only in scale, but also in geography, population size and density and other market characteristics. RAC supports the use of second tier US railroad companies to provide a better comparison. The inclusion of international data which is more closely matched to the Australian experience will make the use of DEA more appropriate. RAC also supports the use of econometric models to assist the analysis.

It is also important when analysing that the use of comparative international models that recognise the relationship between structural models and industry performance. is recognised. If there is no recognition and no parity on this issue then it makes benchmarking of world's best practice artificial in that different models with different performance impacts are being assessed.

2.4 Valid Market Analysis

The Report focuses on rail system performance rather than the performance of individual rail organisations. The rail system has been defined at the Sstate and / or national levels in the analysis. As discussed above, comparisons should only be made between like markets.

The state rail systems in Australia comprise markedly different business mixes. For instance, the NSW system has a far greater commuter market that any other state in Australia. The Sydney and urban network with around 900,000 passenger movements on approximately 2,300 train services everyday is far more logistically complex than several other rail markets such as in Brisbane and Adelaide. The Report's consolidation and comparison at a Sstate level results in a comparison of disparate rail systems comprised of different businesses, that is,ie a comparison of apples with oranges.

It would be more appropriate to compare the States at the end market or business level, f. For instance, comparison coal networks, general freight, grain and minerals freight etc. This point was also raised at the Productivity Commission workshop held in April.

2.5 Data Collection Period and Selection of Appropriate Categories

The data analysed in the report covers the period 1991-92 through to 1996-97. It is erroneous to evaluate the success of reform initiatives to date and make recommendations for the rail industry's future based on data that captures only the first year after rail reform was implemented in NSW. Clearly, the validity of conclusions which fail to take into account data post-1996/97 must be queried.

It is also important that appropriate categories of data be selected to measure performance in order to draw valid conclusions about productivity. Key performance indicators should be chosen on the basis of relevance to industry productivity and should be identified in consultation with industry, for example, infrastructure performance in terms of reliability, below-rail cost and, safety performance should have bee n used. Some of the categories used to measure performance in the Report such as price changes in passenger rates have little relationship to overall productivity gains achieved by the industry given that in all states urban passenger services depend on Community Service Obligation payments ("CSOs")'s.

3.0 STRUCTURAL ISSUES (REPORT CHAPTER 5) - STRUCTURAL ISSUES

3.1 Introduction

TAs set out in RAC's comments on Chapter 2 of the Report, the discussion of horizontal and vertical separation suffers from errors of fact and from usingstarts from a fundamentally flawed categorisation approach which we believe to be problematic.

The discussion of structural issues in Chapter 5 of the Report compounds these problemss by applying flawed logic particularly where there are inconsistencies with the Report's discussion of the issue in Chapter 7. .

RAC is disappointed at the poor treatment of this issue given its critical importance to rail reform and the solid analysis of the related issues in chapter 7 of the Report.

RAC' is strongly of the view is that:

- tThere should be a presumption in favour of vertical separation, with the onus being on those who support vertical integration to prove the superiority of such an approach;.
- tThere should be a presumption in favour of horizontal integration of track ownership; and.
- Tthe market should determine whether above rail operations are horizontally integrated or not.

The following discussion explains RAC's the logic of this position.

3.2 Vertical Separation

Vertical separation is a mechanism to facilitate access to the rail network and through such facilitation, to generate competition in parts of the supply chain which do not possess natural monopoly elements.

Much has been written on the theoretical benefits of competition. The introduction to Section 7 of the Report summarises the case:

> *"… increased competitive pressure may improve market outcomes because competition, or the threat of competition, puts pressure on businesses to operate more efficiently, look for innovative ways to respond to customer needs, improve quality and/or lower prices."*

Despite only having existed for just under three yearsIn practice RAC has already effectively used competitive pressure to improve customer service, quality and prices.

already noted all of these streams of benefit despite the relatively short time vertical separation has been in place:

Competition between operators, and the threat of competition, has driven prices down and forced efficiency improvements[1]. It has also

Competition between operators, and the threat of competition, has pushed service levels up[2]. Further, new o

Operators in particular , particularly new operators, are increasingly seeking out new business opportunities and using improved marketing strategies to win freight from road[3].

Section 7.2 of the Report containshas an excellent discussion of the issues surrounding the development of an effective access regime for access too rail infrastructure. The flavour of the discussion emphasises the difficulties associated with attempting to regulate access to track where the track owner is also the operator.

The Commission's conclusion notes that:

> *"Vertical separation would address any conflict of interest by introducing incentives for the track owner to encourage more operators onto the track, thus removing the need for a strong access regime."*

A number of submissions are quoted in Section 7 that note the potential for a vertically integrated operator to frustrate access to the point where access is effectively denied, despite the existence of a regime. It is also noted that the issues raised are real life issues and have been noted in practice as well as in theory.

Again, the Commission's conclusion is noted:

> "Prescriptive access Regimes may address some of these issues. If the Regime reflects efficient principles and is seen to be transparent and independent, then operators may be confident that they are being offered fair and reasonable terms and conditions. However, the cost of getting the principles wrong can be high. In addition, such regimes may involve greater direct regulatory input (and consequently have higher regulatory costs) than flexible regimes."

Further strong argument in support of achieving access through vertical separation is provided in Bbox 7.4 of the Report. WIn short, while a strong access regime may in theory provide effectively for access, the ability to frustrate its intent means that at best it provides a satisfactory solution only for high volume businesses. Small and medium

[1] For example, Freight Corp reported ~~average rate reductions of x% in its 1996/97 Annual report and x%~~ in its 1997/98 Annual Report that Central Hunter Valley coal producers paid 25 per cent less in average rail freight rates than they were paying two years previously.

[2] For example, National Rail is reported to have won the Macquarie Generation contract primarily because it responded to the service objectives of the customer rather than on price.

[3] For example, a significant proportion of the traffic won by new operator Austrac is new to rail.

size markets will simply not offer the potential returns to warrant an operator pursuing them through a 3rd party approach.

Combining these arguments it logically follows that competition is accepted by the Commission as a powerful efficiency driver and that there are considerable risks with implementing 3rd party access through regulation. These risks can be virtually eliminated by introducing vertical separation.

IRAC believes that it therefore alsologically follows that there should be a presumption in favour of vertical separation unless there is a strong case made out to the contrary. Further, it believes that section 7 of the report has provided a very strong case for this conclusion. RAC is therefore surprised that Chapter 5 of the Report recommends integration for passenger networks and low volume branch lines and potentially for high volume regional lines.

Given the strength of the above arguments the conclusions of Cchapter 5 could only be substantiated through demonstrating an the tangibleonly be substantiated on the benefits of vertical integration. An analysis of the arguments for vertical integration is provided further on in this submissionAs this has not occurred. tThere does not appear to be a case tothat would overturn the presumption in favour of vertical separation.

3.3 Horizontal Integration

RAC believes that any discussion of horizontal integration needs to be considered at two levels, below rail and above rail.

The case of Silverton operations at Broken Hill set out toward the end of Section 7.1 of the Report provides an excellent example of the complexities that arise when there is horizontal separation of the track. RAC believes that horizontal integration of track is highly beneficial in facilitating efficient operations and competition between above rail operators.

Maximising the degree of horizontal integration is equivalent to minimising the number of below rail jurisdictional borders.
Where there is vertical separation between above and below rail, the issue of horizontal separation above rail ceases to be an economic policy issue. In this case, competition in the market place will determine those traffics that are won by any particular operator.

Operators will cross boundaries based on commercial considerations. They could be combined freight and passenger operators on low volume lines, such as Northern Rivers Railroad on the Murwillumbah branch, operators combined across interstate, low volume regional and high volume regional, such as Freight Corp, or any other possible combination. The important issue is that with vertical separation, the market will determine the horizontal outcome.

In an environment of vertical integration and horizontal separation, two concerns arise. First, there is a loss of efficiency where operatorss must cross jurisdictional boundaries. As with current problems on the interstate network, this could arise because of differences in standards or the need for multiple negotiations. Second, the problems of incumbency with vertically integrated operators, as discussed above, are likely to hinder market forces in determining the most efficient structure for above rail operations.

RAC believes that the market is best placed to determine the structure of above rail operators across markets, and that this outcome is best achieved through vertical separation.

ItFinally on this subject, it is also unlikely that it will be possible to create a single horizontally integrated track owner that can provide a single point of access across the entire contiguous Australian rail network[4]. Given this reality, there is a need to develop efficient structures that provide for retailing or reselling of access to provide seamless access arrangements. This is the model currently being pursued by RAC in negotiations with the ARTC to provide seamless access to the NSW network.

3.4 Analysis of Chapter 5 of the Report

3.4.1 The Costs of Structural Separation

Based on its experience with vertical separation in NSW, RAC believes that the alleged costs of vertical separation have been exaggerated. Section 5.3 of the Report sets out a list of issues that have been identified in relevant literature as being sources of inefficiency. The following points discuss these issues.

- *Lack of co-ordination.*

  RAC concurs that there is a risk of poor co-ordination where there is horizontal separation at the track level. For this reason it strongly supports maximisation of horizontal integration at the track level. RAC also accepts that there may be co-ordination problems where passenger operations are horizontally separated at the above rail level, but does not have any experience with which to judge this. RAC does not believe that there is a material co-ordination problem with vertical separation.

  The reality is that there are always above / below rail co-ordination issues whether a business is vertically integrated or not. The NSW experience is that separation forces a much greater level of rigour to be applied to these processes which make

[4] It should be noted that as a result of sections of dual gauge track, the Queensland, NSW, Victorian, South Australian and Western Australian networks form a contiguous whole, covering narrow, standard and broad gauges. The only truly separate networks are the Eyre Peninsula~~r~~, the Pilbara lines and Tasmania. Given that the contiguous network currently has six different owners, a number of which are governments, and includes a number of politically important metropolitan commuter networks, it is highly unlikely that the contiguous network could be consolidated into a single ~~signel~~ entity in the foreseeable future.

transparent and well considered the decisions that were previously taken internally, often on an arbitrary basis. This is similar to some of the sources of benefit that arise from contracting-out. In this way vertical separation results in an increase in the quality of co-ordination.

- *Complication in operational management.*

  T This is a similar issue to the co-ordination issue. The Report specifically cites timetabling, train schedule allocation and capacity management as being areas of potential complication.

  The reality is that in vertically or horizontally integrated businesses there is already a high degree of complexity in these matters wherever high volumes of traffic occur. The impact of vertical separation is that it makes explicit those decisions that were previously taken internally. For instance, the coal industry has for many years expressed concern over alleged inefficiencies that have arisen from coal train pathing practices around Newcastle.

  Separation has allowed increased focus to be brought to this issue and a strategy developed that delivers improved performance for all stakeholders. The only aspect of separation that adds complexity is where operators compete for paths. This can raise equity issues between operators. However, it must be emphasised that this is a function of competition, not separation, and vertical separation will facilitate better resolution of these issues than an integrated environment.

- *Loss of economies.*

  Under RAC's preferred structure, the below rail business is horizontally integrated, allowing it to maximise available economies of size and scope. For the above rail business size, scope and density of operations will be determined by market forces thereby maximising economic efficiency. This will lead to an inherently more efficient outcome than a structure dictated by history, state borders or Government decisions.

- *Price and service administrative complexity*

  . Maximising horizontal integration below rail avoids price and service administrative complexity at this level. RAC acknowledges that horizontal separation of passenger services may create significant costs in this area, but as noted above, has no experience from which to comment. RAC is not aware of any suggestions that vertical separation in NSW has created undesirable levels of complexity in price and service administration between above and below rail.

- *High initial cost of separation*

  . RAC acknowledges that there were significant establishment costs in creating the vertically separated industry in NSW. However, the majority of these costs were associated with addressing the shortcomings of legacy accounting and funding arrangements. Additional one-off costs were associated with establishing the legal relationship between RAC and operators. However these costs are incurred in any contracting-out exercise. Doing this has created considerable benefit by applying rigour and objectivity to decisions previously taken on an arbitrary basis in-house. In any case, now that this hurdle has been cleared by RAC the relevant intellectual capital embodied in standard access contracts, pricing models, and data systems make it easy to replicate the approach.

- *Long term investment planning.*

  T The importance of this issue has been overstated for operators. There is an issue associated with long-term predictability and stability of access rights. However, at present the greatest source of uncertainty for operators is concern that further structural change will deprive them of efficient and fair access.

RAC does not believe vertical separation constrains its own investment planning. RAC now has in place a detailed infrastructure planning process which parallels the process that would be adopted in a well managed vertically integrated business. With vertical separation, the dialogue between business units which supply track capacity and those which demand it is an external, arms-length dialogue, but is not necessarily any less effective or efficient than an internal dialogue.

- *The cost of regulation.*

  In the case of NSW the major costs have been the establishment of the Rail Access Regime, its submission to the National Competition Council for certification as effective, and the additional responsibilities of the NSW Independent Pricing and Regulatory Tribunal (IPART) following the establishment of the NSW Access Regime. All of these costs are effectively fixed independent of the proportion of the NSW network that may be vertically separated. Accordingly, there are no regulatory economies to be achieved by reintegrating parts of the network.

  For other states the cost of regulatory establishment could be minimised by borrowing from the work already done by NSW. On a day to day basis, regulatory costs only arise where there is a dispute. Such disputes are much less likely to arise in a vertically separated model where the interests of new operators align with those of the track owner, than in a vertically integrated business with 3rd party access arrangements. Regulatory costs are therefore minimised by vertical separation.

3.4.2 Specific Vertical Integration Arguments

In addition to the general discussion of the costs of separation, there is discussion through the subsequent sections of the Report, particularly in the low volume regional section, on specific arguments for integration. Given the emphasis RAC places on the need for pro-integrationists to make their case, the following discussions looks at the arguments in detail.

The benefits of competition (see Appendix 5) demand that a positive The presumption should always be in favour of separation unless there is a good argument for integration. To do otherwise is to deny customers choice and deny the rail industry the opportunity to maximise its performance.

The view of Maddock as reported by the Commission in Section 5.4 takes the reverse position. It argues that in the absence of a good reason to separate, the operation should be integrated. As argued above, the prima facie case for separation is strong. Maddock's argument does not provide any reason to reverse the presumption in favour of separation. The reported comments of QR similarly start from a presumption in favour of integration and do not provide an argument for integration.

The reported comments of Australian Transport Network (ATN)N seek to provide some substance to the argument for integration. ATN has argued that "*in a separated model, either there is an artificial division of primary responsibility, and later debate and settlement; or the prospect of litigation and significant costs.*"

This is certainly a legitimate consideration, however RAC believes that the view fails to take account of the significant commercial benefits and efficiencies that could be gained through structural separation, subject to **appropriate accountabilities being in place.**as it is in any contracting-out exercise[5].

The issue becomes one of materiality, that is, do the co-ordination issues and strategic considerations associated with contract management exceed the efficiencies from contracting-out for a given task. Unfortunately there is no detail provided.

HHowever, it is possible to consider the likely issues. In RAC's experience, these will be associated with three areasIn RAC's experience-; track maintenance,; train control and; standards are three key areas which counter ATN's view.
.

With regard to track maintenance, this is now almost universally contracted-out to track maintenance specialists and it is unlikely that any operator would argue strategic advantage for retaining this task in house. Through RAC's alliance contracting arrangement (see Appendices 1 and 2) RAC has established strategic advantage in being able to create competition in a functional area for which we retain primary responsibility.

Insourcing train control has a slightly higher level of justification. However, it is worth noting that Freight Corp's has chosen to contracting out of the train control function for the Leigh Creek line to ARTC also provides an example where effective commercial arrangements can be established which allow key industry players to retain effective primary responsibility for service delivery. rather than keep it in house. Train control on low-volume lines is a relatively mechanical function and has little strategic value in this instance strategic value. It is therefore logical that it be structured to minimise cost. Therefore while under its arrangement with ARTC FreightCorp maintains primary responsibility for train control, it has freed up its own internal resources to focus on its core in-house tasks.

Track standards are a more contentious issue. There is a genuine risk that the objectives of a track owner will not align with those of an operator, as the track owner will be endeavouring to minimise track maintenance costs and safety risks while the operator will be attempting to minimise above rail costs. There is a legitimate argument that an integrated operation will be more dynamic in developing standards that minimise the total rail cost.

However, there is a counter argument that in a vertically separated environment the track owner retains strong commercial incentives to minimise total costs. Furthermore, while there may be some transaction costs associated with resolving changes to track standards, the need for the track owner and operator to make their respective cases for a change to standards provides a sound foundation for the application of rigorous and objective analysis. Such analysis has often been lacking in the past in vertically integrated operators, and in particular, the debate has tended to be dominated by inherently conservative engineering divisions.

[5] ~~Track access can be readily characterised as a contracting-out exercise. Indeed, National Rail has described it as such in comments reported under Section 6.2 – Government Procurement.~~

RAC's experience to date has been that Freight Corp has higher expectations of RAC performance with low volume lines than it did of itself as a vertically integrated operator. At the same time, RAC has demonstrated responsiveness to requests from operators such as National Rail and Austrac to vary standards and is now moving to pro-actively review standards with a view to delivering operator cost savings.

In conclusion, while there may be some loss of efficiency from separating responsibility for standards RAC believes that it is unlikely to be material and that it certainly falls far short of providing a case to override the presumption in favour of separationcompetition.

The comments of the CRT group are again interesting in the context of competition. It puts forward an argument that the ability of an operator to invest is maximised through vertical integration.

RAC doubts that there would be a question over its own ability to invest. RAC has a very strong balance sheet and a stable revenue stream. The issue cannot therefore be the inability to invest in the below rail business. Rather it must be the ability to invest in the above rail business. In fact, a vertically integrated but horizontally segregated low volume train company may have far less capacity to invest due to lack of balance sheet strength.

The capacity of above rail operators to invest in a vertically separated environment is a function of their own performance, that is, they are considered on their merits. The argument as put forward by CRT must then be that through integration there is greater capacity to invest in the above rail component of the business, as the merits of the operator are enhanced by control of the track. In turn, this can only come about because the risk of above rail competition is largely eliminated by integration. In other words, the integrated rail operator's capacity to invest is driven by the prospect of monopoly rents.

This argument is analogous to the views of, Ed Burkhardt, Chairman of ATN parent company, Wisconsin Central, (described in the as set out in the article from IInternational Railway Journal article in Appendix at attachment 4). The essence of his argument is that open access weakens operators because revenue that could otherwise be extracted from customers is competed away.

These arguments are clearly founded on anti-competitive concepts. Unless the Productivity Commission is prepared to support an argument that competition is inherently undesirable, then the arguments should be rejected as specious.

The comments of the WA Government that "vertical integration enables the railway to maximise efficiency", assumes that the railway has both the technical expertise to solve a difficult optimisation problem, and the will to maximise efficiency. In the absence of competition that will is unlikely to be strong.

In RAC's view, no strong case has been made that would overturn the presumption in favour of competition.

3.4.3 Market Specific Discussion

The Report considers the case for vertical and horizontal separation on a market by market basis. RAC believes that while this approach is an improvement on universal prescriptions, nonetheless it is fundamentally flawed as the case for integration versus separation should be based on the specific characteristics of subnetworks and the traffics that pass over them. For instance, RAC does not believe that it is possible to draw a general conclusion on high volume regional networks when this category encompasses such disparate networks as the multi-user, multi-customer Hunter Valley and the single-user, single customer Pilbara iron ore railways.

The following section is organised to follow the market based approach to provide specific responses to the issues, while drawing on the preceding discussion.

3.4.4 Urban Passenger Services

The Rreport argues that urban passenger services should be both horizontally and vertically integrated, noting that competition in passenger markets is likely to be limited.

In the case of Sydney (and to a lesser extent some other major cities), there is considerable overlap of markets that make horizontal separation impractical. Attachment 3 shows the Sydney metropolitan network and specifically identifies those lines where the State Rail Authority ("SRA")SRA is the single operator.

If the Sydney network were reintegrated vertically, access requirements of freight operators would mean that State Rail SRA would need to either create an access unit and thereby introduce further jurisdictional boundaries for operators, or it would need to establish a retailing arrangement with RAC and/or other access providers. Alternatively, SRA could be horizontally integrated (that isie, take responsibility for the entire NSW rail network) in which case statewide access would be managed as a side business—a distraction of SRA management attention from its core commuter transit business.

There is a further significant issue in terms of the manner in which the infrastructure is managed. A convincing case is set out in section 6.2 of the Report for the contracting out of services. Track maintenance is a function that is ideally suited to contracting out and it is now common practice across Australian railways to contract-out this function.

Management of the process of contracting-out maintenance and subsequent management of the contract is a specialised task. As an operator, SRA State Rail management time is best focussed on management of the above rail passenger business and improvement in its performance rather than being distracted by track maintenance issues. A separated structure effectively provides for State Rail SRA to contract to RAC management of the track.

Indeed, it is worth noting the complexities that have been necessary to franchise the Melbourne passenger services as vertically integrated operations. Box 6.4 notes that, the contracts effectively takes the form of two separate agreements, a franchise agreement and an infrastructure agreement. Given this approach little appears to have been gained by managing them as an integrated process.

Train control and timetabling are different issues again and, particularly where passenger traffic is dense, these need to be handled in a highly collaborative and integrated manner. This is the approach that has been adopted in NSW by RAC contracting these functions back to SRA through an alliance contract.

In summary, vertical separation of the track allows horizontal integration across markets, creating seamless access for operators, and allows SRAtate Rail to focus on the above rail business, while RAC as an infrastructure specialist focuses on managing track maintenance and development.

In the case of Sydney therefore, there are significant benefits from vertical separation in the urban passenger market.

3.4.5 Low Volume Regional Railways

RAC does not accept the Report's statement that "*many low volume regional railways are particularly suited to horizontal separation*".

Certainly the Tasrail business, the Eyre Peninsula Railway and the South Australian broad gauge lines are stand-alone businesses and can readily be horizontally separated. However, these represent a tiny proportion of the rail network.

Standard gauge lines in Victoria, South Australia and Western Australia, which either have been or are about to be privatised as vertically integrated entities, are integral parts of the standard gauge network. Services on these lines almost invariably cross onto the national standard gauge network. The NSW, Queensland and narrow gauge Western Australian systems all enjoy a healthy mix of traffics from high volume bulk movements to low volume tasks. In each case there is considerable movement of traffics between high and low volume lines.

The view that low volume branch lines can be horizontally separated without creating jurisdictional boundaries is, for the majority of lines, mistaken. .
RAC also strongly disagrees with the statement that "vertical separation is unlikely to deliver any significant competitive gains for low volume regional railways because they already face strong intermodal competition".

Two counter-examples come from the NSW experience post-vertical separation: new entrant Austrac has managed to generate new general freight business from Young, and log traffic from Bungendore. Both of these locations are on low to very low volume branch lines. In both cases it is traffic that the original incumbent operator, Freight Corp, had failed to pursue. National Rail has secured the haulage of aggregates from the Boral quarry at Shellharbour to Sydney, a traffic that was lost to road, by Freight Corp, some years ago.

Some may argue that under private ownership Freight Corp would not have ignored these traffics. However, private ownership is no guarantee of good performance. Another interpretation of these counter-examples is that low cost operators such as Austrac offer freight forwarders a different value proposition than firms such as Freight Corp with different competitive strengths. It is the diversity of value propositions which makes vertically separated rail transport more attractive. Only the opportunity for competition can maximise the possibility that rail will attract as much traffic from road as it is capable of doing.

RAC is aware of a large number of new business opportunities that operators are pursuing for the NSW network. The opportunities are across a very large proportion of the NSW network and are being pursued by a variety of operators. It is inconceivable that in a vertically integrated environment there would be this level of market development taking place. RAC does not therefore accept the statement that “vertical separation is unlikely to deliver significant competitive gains” for this market.

The conclusion of the Commission following the discussion of the low volume regional issues is that “it is most efficient for one operator to meet the needs of the markets served by low volume regional railways.” RAC strongly questions whether one operator will meet the needs of the markets or that the end customers will be satisfied with a single choice of rail operator.

Furthermore, as discussed at length in earlier sections, RAC does not believe that a case has been made by pro-integrationists that would justify overturning the presumption in favour of separation.

RAC also notes that the principle argument in favour of integration of low volume lines appears to be the presence of strong intermodal competition. It would logically follow then that the interstate network should also be recommended for integration, as it is subject to equally strong, or stronger, levels of intermodal competition. For the Commission to have arrived at different conclusions for the two network types is a logical inconsistency.

In regard to horizontal separation of above rail operations, the market should be allowed to decide the outcome as discussed above. Whether low volume business is most efficiently operated by niche operators or by large horizontally integrated above rail businesses, the market will determine the outcome provided there is vertical separation that allows the market to operate effectively.

3.4.6 High Volume Regional Railways

The report does not provide any guidelines as to what represents a high volume regional railway. Based on the discussion, RAC assumes that it is intended to refer to the Hunter Valley and Queensland coal lines and the Pilbara railways.

With respect to vertical separation, the arguments of the previous section apply equally but the greater scale and economic importance of high volume railways heighten the concerns raised by vertical integration and the prospect of monopoly rent-taking. As volumes increase and the number of customers increasess, the importance of competition also grows and the presumption in favour of competition should also grow.

Where a line is dedicated to a single customer or consortium of customers,,. such as applies in the Pilbara and Leigh Creek, it is logical for the customer to control the line and, if it choses, to operate as a vertically integrated business. Such an arrangement does not preclude competition, since the customer ultimately retains choice.

The Commission may have extrapolated from this rather unusual circumstance and applied the Pilbara prescription to all high volume freight networks. In the case of the

Hunter Valley coal system RAC believes that coal miners would agree that monopolistic behaviour by a vertically integrated rail operator would be far more detrimental to their interests than the transparently regulated system in place since vertical integration was introduced in NSWJuly 1996.

3.4.7 Interstate Network

RAC strongly supports the horizontal integration of the management of the interstate network. For rail to realise its full potential on interstate corridors it is essential that access arrangements be streamlined and that pricing and investment decisions are made on a network basis rather than a jurisdictional basis.

RAC is pursuing horizontal integration through a resale agreement with ARTC. There have been some suggestions that ARTC should take control of the track sections that are predominantly used for interstate business as a means of achieving horizontal integration. This is an unsophisticated solution to the problems of integration.

The geography and traffic patterns on the NSW network mean that any such transfer of track would create additional jurisdictional boundaries. T- thisat would inconvenience more traffic than the existing boundaries, particularly given the impossibility of ARTC managing from Adelaide the Sydney commuter network (see map at Appendix 3 **[see attached interstate freight map at the end of this chapterdiagram*]**.). RAC does not, therefore, support transfer of track to the ARTC.

A resale or retailing approach is a more sophisticated solution that deals with the underlying issue, that is, the need for a single point of contact. RAC believes that its customersown performance will benefit from creating seamless access for interstate services and is therefore pursuing the negotiations for its own commercial benefit.

However, an impediment to this commercial approach has arisen from the provisions of the Inter-Ggovernmental Agreement governing the establishment of the ARTC, in that it provides for ARTC to hold an exclusive right of access for interstate services on the interstate network. This is creating problemspractical issues in defining what is an interstate service and leading negotiations down a legal rather than commercial path. It also increases the risk of “gaming” by operators. RAC is concerned that in some cases the exclusivity provision will lead to an increase in complexity for operators rather than a reduction.

RAC believes that the ARTC should be able to effectively establish itself as the point of contact for interstate operations by genuinely adding value for operators. RAC is concerned that ARTC’s exclusive right to sell access may be removing the incentive for ARTC to focus on this value-adding role. At the same time, RAC is unaware of any argument that supports ARTC having a mandated monopoly over selling interstate access.

RAC concurs with the Commission's view that the appropriate structure for the interstate network is vertical separation. Adopting the presumption in favour of competition, there are strong reasons for vertical separation of the interstate network.

3.5 Conclusion

RAC believes that by the Commission's own arguments as set out in chapter 7 there is a very strong case that vertical separation should be preferred over vertical integration. unless there are strong arguments to support integration in specific cases. NoIt does not believe that any such arguments have been presented in chapter 5. RACIt therefore strongly disagrees with the conclusion that some markets are best served by vertically integrated railways.

In regard to horizontal separation, RAC has argued that such separation should be minimised at the track level to avoid inefficiencies at jurisdictional boundaries. Accordingly it again disagrees with the Commission's conclusion that some businesses should be horizontally separated.

Finally, it has outlined how, if the principles of vertical separation and horizontal integration of track are followed, the market will determine the most efficient structure at the above rail level.

4.0 PRIVATE AND PUBLIC PARTICIPATION (REPORT CHAPTER 6) – PRIVATE AND PUBLIC PARTICIPATION

4.1 4.1 Introduction

RAC notes the Report's discussion of privatisation issues.

RAC does not have any preferencesold a concerningview on the performance of Government owned operators compared to private sector operators. RAC does, and will continue to, treat operators impartially irrespective of ownership structure.

4.2 Private Sector Participation in Infrastructure Development

The Corporation does, however, recognises the benefits of introducing private sector participation into the below rail business. The diversity of skills and access to innovativee funding strategies that can be accessed by introducing the private sector into infrastructure development may see greater private sector involvement in strongly suggests that this will be the preferred approach to future major infrastructure projects.

RAC is currently developing strategies to introduce private sector partnering into the future development of the NSW rail network as a means to leverage the available Government funding. In this way RACit aims to increase the level of investment in the network without additional recourse to Government funds.

4.3 Privatisation and Vertical Integration

As discussed extensively in this submission, RAC strongly supports a vertical separation model. Clearly this is an issue that has not yet been fully resolved. There is a current trend for rail businesses to be privatised as vertically integrated businesses and it is highly likely that this flows from Governments falling into the "sale value maximising" trap outlined in the "Privatisation" section. In short, the sale value is maximised at the expense of customers, competing rail operators, rural and regional communities and the economy generally.

The risk is that Governments, in selling track assets today, are locking-in a structure that has not been proven to be the best approach. Furthermore, as outlined elsewhere in this submission, there is a risk that those businesses that are vertically integrated and also operate in contestable markets may distort those contestable markets resulting in a reduction in economic efficiency.

In contrast, where above rail assets are sold on their own, it does not preclude reintegration in the future if there is strong evidence over a meaningful time period that vertical integration is the best structure. This could occurSuch evidence would be where, for instance, where, market forces resulted in a single above rail operator and available traffics were never contested (ie, there was no threat of competition) despite vertical separation.

However, by predetermining market structures those Governments that sell rail businesses, particularly freight businesses, as vertically integrated operations are probably causing a significant reduction in community welfare over time.

4.4 Franchising of the Track Ownership Function

This submission has extensively argued the case for vertical separation and for contestability of track maintenance contracts. It has generally argued these cases on the basis of the benefits of competition.

Adopting such an approach inevitably leads to a position of Government retaining control of the track ownership function. However, while RAC supports perpetual Government ownership of the essential track infrastructure, it notes that this does not preclude the franchising of the track management function. There is no apparent reason why the functions provided by a track owner such as RAC could not be franchised through a contestable process, provided that above rail operators, and maintainers, were precluded from bidding.

However, RAC notes that the potential efficiency gains from such a strategy are likely to be limited as the track management function itself requires only a small workforce. There may be some scope for efficiency gains in the quality of investment strategy and standards setting, but these are unlikely to be dramatically enhanced by privatisation of an already corporatised function.

5.0

6.0 5.0 CHAPTER 7 – ACCESS TO RAIL INFRASTRUCTURE SERVICES (REPORT CHAPTER 7)

5.1 IntroductionOverviewIntroduction

As discussed above, RAC broadly endorses the comments and conclusions of section 7 of the Report.

However, RAC has a number of specific comments on issues arising in the discussion in this section.

5.2 Access Pricing Arrangements

RAC would like to draw to the Commission's attention two important aspects of the NSW Rail Access Regime not specifically outlined in Box 7.2.

First, the ceiling test is required to be applied on a "combinatorial" basis. The test provides that on any line sector, or group of line sections, and for any operator, or group of operators, the revenue does not exceed the ceiling. This is an extremely stringent test to preclude any form of cross-subsidy. RAC compliance with this test has been reviewed in the context of the current IPART review of aspects of the Rail Access Regime.

At various locations in the report (eg section 6.2 – Is Corporatisation Sufficient, sectonsection 7.2 – Characteristics of Well Designed Access Regimes, …) allegations of cross-subsidy have been made. As explained, the Regime is stringent in precluding cross-subsidy and in the event that any customer is genuinely concerned that cross-subsidy is taking place it is open to that customer to seek arbitration through IPART.

Second, the coal specific pricing principles are consistent with both the terms and the intent of the Competition Principles Agreement and in accordance with that Agreement are being phased out, with expiry on 30 June 2000.

5.3 Which Markets?

Under the section headed "Which Markets?", the Commission endorses the view of Rail 2000 that "*there are certain branch lines that if you have an open slather, open access policy, are never going to turn a dollar*."

This is clearly wrong in logic. It is a fundamental principle of competition that competitors will only remain in a market if it is profitable or strategically beneficial to them. To argue that competition leads to losses is to argue against the underlying logic of a free market economy. It is the equivalent of arguing that a monopoly position should be entrenched to protect operators from themselves, as otherwise they may cut rates too much.

This argument certainly does not substantiate the previous paragraph of the Report that suggested that there are certain lines that may only ever support one operator. While a line may only support one operator at a time, competition "for the market" means that the customer's choice of operator may change from time to time. To preclude access in this circumstance is to ultimately preclude customer choice.

Similarly, to argue in the next paragraph that "*formal access regimes are likely to be unnecessary in markets where existing train operators and track owners have reached private agreements*" is to have a strictly static view of the world. Even under these circumstances rail access rRegimes may be necessary to facilitate the entry of third party operators who may arise in the future and to whomwhich the incumbent track operator(s) or ownerowner may have commercial reasons to seek to preclude from access for commercial reasons.

Consequently RAC disagrees with the conclusion that:

"*Access regulation is unlikely to improve performance in rail markets where: it will only ever be cost effective for one train operator over a given line; or train operators and track owners have reached private agreements.*"

RAC also notes that access regulation has high fixed costs and low variable costs. Accordingly, if one market is to be regulated, then other markets can be regulated for minimal additional cost. RAC agrees with the conclusion that the benefits of competition must exceed the costs of regulation, but maintains that in the Australian environment there is very little track that could reasonably be excluded from access regulation on this basis provided efficient and sensible regulatory processes are in place.

5.4 An Appropriate Level of Flexibility

This section of the report discusses price discrimination and refers to discrimination at the level of "operators". RAC does not practice price discrimination at this level to avoid the risk of breaching neutrality principles. However, it does price discriminate at the level of traffics but strictly on the basis that operators pay the same price for the same traffic. In the future it may discriminate for different service specific characteristics used for carrying the same traffic where costs of the service characteristics vary (eg, axle load, time of day), but a given price will always be available to any operator with the same service characteristics. RAC would not support price discrimination between operators purely on the identity of the operator.

5.56 Auctioning of Train Paths

RAC does not support the concept of auctioning of train paths.

RAC's primary objective is to satisfy the market demand for train paths. To the extent that a particular path may have a premium value, this reflects scarcity of that path. RAC's preference is to provide adequate capacity to fully meet market demand.

To the extent that the market is not met, this reflects under investment in the network. The Sydney – Melbourne business provides a good example. Rail currently has somewhere in the order of 20% of this market. This market share is achieved with a single 1,500 metre train per day[6]. Even in the unlikely event that rail was able to secure 100% of the market, this would still only represent five 1,500 metre trains per day. If the assumption is further tightened so that the entire market wanted to be serviced overnight, this would still only require that the 5 trains leave at half hour intervals. Such a scenario is readily achievable with modest investment in the infrastructure.

If access is properly priced it provides appropriate incentives for the track owner to invest to accommodate the demand. Accordingly, supply and demand are matched and there is no need for auctioning.

RAC's other concern with auctioning is that it may have a negative impact on the market. If a rail operator needs to invest time and resources in developing a market, it will only do so if it has reasonable certainty over its train path. Under an auctioning system there is a risk that operators will be discouraged from market development. Further, it may be unjust to operators for the track owner to capture, through the auctioning process, the value that the operator has created through its market development activities.

Finally, it may not be necessary to move to an auctioning system to adopt market mechanisms to allocate paths. Time of day pricing for train paths, either on a posted or negotiated basis, can achieve similar results without resorting to the administrative complexity of auctions.

[6] Note that the Austrac train is primarily a Sydney – Junee and Junee - Melbourne train. The Freight Corp service carries traffic that was on the National Rail service and could be accommodated on a single 1,500 metre train. Also note that this is not the only traffic in the corridor. There are also steel, Melbourne – Brisbane, grain, intrastate general freight and passenger services.

PRODUCTIVITY COMMISSION REPORT
PROGRESS IN RAIL REFORM

CHAPTER 8: SAFETY REGULATION AND OPERATING STANDARDS

7.0 6.0 SAFETY REGULATION AND OPERATING STANDARDS (REPORT CHAPTER 8)

6.10 OverviewOVERVIEW

Rail Access Corporation RAC recognises that some efficiency problems have occurred in the implementation of safety regulation in NSW, particularly in the area of interstate operations.

Further, reform of safety safety regulation management reform must recognise the rail industry's fundamental shift to a commercial structure and the intense competition that exists between road and rail. Poor safety has significant commercial implications which give commercial operators tremendous incentives to establish high quality safety regulation and operating standards .

At the same time rail cannot afford excessive and inappropriate regulation if it is to be competitive with road. RAC therefore believes that the best approach to safety regulation is to adopt a co-regulatory model, which allows industry participantslayers to regulate safety on a day to day basis within a broader safety framework agreed at a State and national level framework. .

A strong, independent regulator whose role is to oversee compliance should be established.

While RAC supports the establishment of a national regulator to oversee compliance with such a framework which has responsibility across inter-state and intra-state rail operations, itThe Corporation opposes the establishment of a national safety regulator with responsibility only for interstate lines and/or traffics only. This as, for NSW this would beis impractical and inefficient in NSW, given the commonality of lines for both intrastate and interstate markets.

Further, RAC does not does not support the Regulation of standardssetting or regulation of safety standards by the regulator, is not supported as these are fundamentally commercial decisions and regulation would restrict innovation and productivity. However, aAccelerating the pace of harmonisation by allowing track owners and operators to apply commercial discipline in a co-regulatory environment is supported. This process should be facilitated by the ongoing development of Codes of Practice.

A Land Transport Commission should facilitate a common approaches to standards and regulation at a national level in the context of a commercial approach. This co-ordination role would not however be is not appropriate for a safety regulator as it would potentially distract from its core safety role.

6.2 Co-Regulation: the Preferred Safety Regulation ModelSAFETY REGULATION

6.2.1 General

In RAC's view, the optimal level of rail safety and efficiency would be delivered through a co-regulation model. The implementation of this model will also facilitate an appropriate level of accreditation fees and eliminate .

While there has been some duplication betweenof the roles of the track owner and regulator. under this model under the NSW co-regulation model, in RAC's view this can be largely minimised by appropriate implementation of the model. Further, the model needs to accommodate the track owner's duty of care to ensure safety on its network. These issues are addressed below.

RAC agrees that current safety regulation practices particularly across State boundaries, are unnecessarily complex and costly..

The complexity ofin rail safety regulation across Australian jurisdictions has been due primarily to a few key factors. They may be summarised as:

- a high level of intervention by regulators at a detailed level;
- frequently variation ofying 'Accreditation Guidelines' issued by regulators, particularly those being developed nationally;
- differing interpretation or application of regulation between States;
- overlap of control between track owners and regulators;
- industry participatntsparticipants have had a steep learning curve in relation to the application by all parties of the new safety regulationActs; and
- unclear organisational roles within the new disaggregated rail industry.

Other safety regulatory areas and Acts by which the Corporation is bound eg NSW Electricity Safety Regulations adopt a more practical approach to safety regulation which also ensures a high standard of safety regulation. This approach of defining what must be regulated however, allows individual organisations to develop and manage safety systems within their own environment through balancing commercial priorities against required safety standards.

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6.2.2 The Co-regulation Model

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RACThe Corporation believes effective rail safety regulation should occur through a co-regulation model. The model comprises the following elements :

- a safety system accreditation (the external element);
- the requirement for each rail organisation to have an appropriate safety system such as that described in AS4292, Rail Safety Management;
- internal safety controls and management within each organisation;
- specification of operating conditions by owners; and,
- non-mandatory industry Codes of Practices, compliance with which is deemed compliance with the safety regulation.

The key to this co-regulatory model would be is the accreditation of thean organisation's safety system by the regulator, followed up with regular monitoring of performance.

The external element (, ie government based accreditation), should:

- be based on acceptance of an organisation's safety systems and performance monitoring;
- be nationally consistent;
- exclude technical or operational standards;
- recognise the role of the track owner;
- not overlap other safety legislation;
- be minimally interventionist; and
- generally exclude maintainers from the requirement of accreditation, as this creates overlapping or dual responsibilities to the owner and accrediting authority.

Safety standards, at a technical or operational level, should not form a part of or be set by regulation. Safety standards are usually integrated into operating standards except for a small number of base operating standards ie "no go" limits. Safety is managed by a combination of standards and practices which, taken individually, may not be the same across similar organisations.

How this balance is achieved is a commercial decision and contributes to ongoing productivity improvements.

For example, an organisation may decide to have very conservative condemning limits for wear on a piece of equipment or infrastructure, but inspect less frequently than another organisation with less conservative limits.

The co-regulation model has been successfully adopted and implemented in other areas of safety regulation by which the Corporation is bound, such as electricity safety.

Regulation in such areas has delivered a high standard of safety. The approach in these areas has been to define the scope of the regulation but allows individual organisations to develop and manage safety systems within their own environment through balancing commercial priorities against required safety standards.

6.2.3 Accreditation Costs

RAC agrees with Recommendation 8.1 of the Draft Report that interstate operators should only pay a single fee. Further, the fee should be consistent across all jurisdictions.

Accreditation fees currently levied are both inconsistent and do not relate to justifiable levels of monitoring, risk or value adding service. TCurrently, the accreditation fee in NSW is based on cost recovery by the NSW Department of Transport ("DoT") and is directly related to DoT's staff coststhe level of staff. An approach to regulation based on accreditation and monitoring will reduce the resources required and in turn this should lower accreditation fees.

RAC agrees with Recommendation 8.1 that interstate operators should only pay a single fee. Further, the fee should be consistent across all jurisdictions.

6.2.4 The Roles of the Regulator and Track Owner

The NSW Rail Safety Act NSW (1993) *)* was written before the restructuringsplit of the NSW rail industry in that State. It does not recognise the role of the track owner in a deregulated industry. Other States have similar problems in that their rail safety regulation legislation does may not recognise subsequent structural changes that have occurred in their industry . This has led to been a source of confusion and debate in areas where responsibilities or rights of the track owner and regulator overlap and/or have not been agreed or defined.

The Draft Report states that "owners can also impose additional requirements" to those of regulators. Similarly, the statement is made that "in addition to accreditation, potential operators must meet any operating requirements of the track owner which are different to that required by the accreditation authority."

These comments reflect a misunderstanding of, (or frustration with), the respective roles of the regulator and track owner. The regulator can accredit an operator's safety system but cannot set the operating conditions for particular services. In seeking accreditation from the regulator, an organisation needs to be firstly aware of this distinction and secondly reference the track owner's requirements in their accreditation application. RAC's safety operating requirements are designed to ensure the safety and commercial interests for the particular train, route and timetable requested.

Rail Access Corporation RAC strongly believes it has a direct role and responsibility for specifying maintenance and minimum operating standards on its network. This is not a function that can be provided by a regulator.

TAccompanying this role derives from RAC'sis a duty of care to ensure that minimumthose standards are met byat an individual operators, whose activities's level as it impacts on all operators and members of the public who use the network. RAC discharges its This duty of care is currently exercised through various regulatory mechanisms such as audits and the monitoring of performance, . RAC's interests in ensuring safety are based on both the general public interest and its own commercial interests. T and as these two components often cannot be separated; they are incorporated in contracts with operators and service providers.

The Productivity Commission Report states that,

"owners can also impose additional requirements"

to regulators. Similarly, the statement is made that:,

"In addition to accreditation, potential operators must …. meet any operating requirements of the track owner which are different to that required by the accreditation authority."

These comments reflect a misunderstanding of, (or frustration with), the respective roles of the regulator and track owner. The regulator can accredit an operator's safety system but cannot set the operating conditions for particular services. In putting forward an accreditation application to the regulator, an organisation needs to be firstly aware of this distinction and secondly reference the track owner's requirements in their accreditation application. RAC safety operating requirements are designed to ensure the safety and commercial interests for the particular train, route and timetable requested.

In the United Kingdom theis problem of duplication between the roles of regulator and infrastructure owner has largely been overcome by adopting a system of tiered "safety cases" in the (accreditation process). RailTrack (the UK infrastructure owner) hasve itstheir safety case approved by the regulator and operators in turn put their safety cases to RailTrack.

In NSW a similar this system is proposed for maintenance contractors whereby only the owner, of rolling stock or infrastructure, will be accredited ie there would be no direct accreditation of contractors.

The Corporation RAC is working with the NSW DoT to resolve these issues and in particular see that appropriate changes are made to the amended Rail Safety Act which is due to be passed this year. Clearly published industry guidelines, and consistent application of legislation, are required in order to reduce cost and frustration for new entrants to the rail industry.

6.3 A National Approach to Safety Regulation

6.3.1 The Role of a National Regulator

RAC supports the establishment of a national safety regulator with responsibility across all inter-state and intra-state rail operations.

However, RAC opposes the establishment of a national safety regulator with responsibility for interstate lines alone. Given that in many jurisdictions including NSW there is no separation of intrastate and interstate lines, demarcation of management responsibility on such a basis would be impractical.

This e national regulator should have responsibility for monitoring accredited industry participants for compliance with safety standards. However, for the reasons described below (section 6.3.2), the national regulator should not be responsible for setting those standards nor for directing which standards should be adopted by accredited rail entities.

The Report suggests that the road or air transport regulation model could be adopted for national rail safety regulation. While the proposal has some merit, it fails to recognise the fundamental differences between road and rail.

Rail is considerably more complex than road or air in relation to the interaction of train/operator with the infrastructure/owner. The rail infrastructure owner both because of its commercial policies and local differences in infrastructure will have an ongoing need to stipulate standards which suit local operating conditions. This requirement must be recognised within any regulatory regime.

RAC supports the third option described in the Report as the most viable. The proposed Land Transport Commission should be responsible for developing national safety regulation but States and Territories should retain responsibility for legislation and enforcement of such regulation.

A Land Transport Commission could also facilitate uniformity, where justified, of technical and operating standards. Its output may be in the form of recommended Codes of Practice for new or substantially modified systems, infrastructure or rolling stock. As noted earlier however, this is not a regulatory role.

Currently this role is managed by industry participants through the ARA and the Standing Committee on Transport, via Industry Reference Group. However since the ARA has limited resources and focuses on promotion of rail to government, this role would be better shifted to the proposed Land Transport Commission.

RAC supports the Commonwealth Government taking a leadership role in advancing regulatory reform at a national level. This would be a logical extension of the process already underway under the Standing Committee on Transport.

6.3.2 Operating Standards and Procedures

RAC does not support regulation of safety standards, either at a national level or by uniform State legislation. Standards development, harmonisation or uniformity is, and should continue to be, driven by commercial pressures for improved productivity and market share. Standards regulation is not necessary for safe operation and there are justifiable commercial reasons for differences within and across rail systems.

As the Report notes, rail systems in Australia are working co-operatively to remove existing anomalies in operating practices and to provide industry based Codes of Practice via the ARA and the Industry Reference Group under the Standing Committee on Transport.

National standards should be developed for minimum operating standards for interstate rolling stock specifying safety critical interfaces between track and infrastructure. This would facilitate mutual accreditation across State boundaries. However, in RAC's view, where local operating or infrastructure differences exist, the track owner should still be able to impose local operating requirements.

Differences in most standards mostly occur because of industry participants' different commercial needs. RAC opposes the proposition that standards be subject to regulation. Uniformity in infrastructure or safeworking standards may reduce direct costs marginally for operators but at a potentially high cost to track owners and in turn the industry. Each case for uniformity, particularly if being considered retrospectively, needs to be considered on its own financial and safety merits.

Attempting to externally specify or regulate non-safety critical standards directly encroaches on an organisation's ability to effectively manage its own business costs and risks.

Radio systems standards have been identified as an example of an inconsistent approach across States that adds to cost and complexity for operators. While this is correct, a practical solution that would have widespread industry support will not be found by government regulation or an enforced uniformity of standards. In developing any standard there are many safety and commercial considerations to be taken into account. Owners and operators, who already have a common incentive to increase efficiency, should be allowed to manage such issues with due respect being given to both their common and separate needs.

The other factor that weighs against government regulation and enforced uniformity of standards is the ongoing development of new technology and operating approaches. These developments will make it difficult to keep regulation up to date and uniformity meaningful across the industry. A further result will be that a technical and operating regulation group would be attempting to dictate business policy or perhaps manage by industry consensus. Either way would not assist the industry to remain competitive.

6.3.32.5 Best Practice Regulation

Rail Access Corporation RAC supports in principle rRecommendation 8.2 of the Draft Report regarding COAG best practice regulation. The CorporationWe believes that the co-regulation model described above can provide the necessary level of safety assurance for the public and government while being minimally interventionist and less costly than the current approach.

The Productivity Commission Draft Report regarding mutual accreditation states that

"competition among regulators is enhanced, resulting in a more efficient regulatory environment in the long term." RAC

Rail Access Corporation questions this proposition, which requires at least some this concept and believes at the least it requires clarification. If uniformity in regulation is introduced then competition is not relevant unless individual State regulators choose to have different treatment of applicants. The promotion of "competition among regulators" would be likely to lead to industry participants forum process of shopping around for the best regulation deal, which would seem to be the anthesis of good regulation.

6.3.42.6 Industry Codes of Practice

Codes of Practice, developed by the rail industry for national adoption, are desirable. However, RAC considers that Codes of Practice should not be imposed by regulation and therefore does not support Recommendation 8.3 of the Report.

Industry The Codes of Practice provide a valuable reference to a uniformity of approach to operations, rolling stock and infrastructure. The Codes provide a ready set of safety standards for easy adoption by any organisation seeking uniformity or a ready, default set of standards for entry into the rail market. However, Codes They will not be are not relevant in total to all rail organisations. The Codes need to be "living" documents that are updated with industry experience in order to enhance productivity and industry development.

However, as the Productivity Commission Draft Report notes, the Codes of Practice are concerned with more than just safety. In many cases they are prescriptive and for this reason should not, (and were not intended to be), mandatory or regulatory. Implementation of any mandatory or regulatory Codes will often be costly and unjustified until replacement or upgrading of systems, rolling stock or infrastructure is required. While some items covered in the Codes can be implemented quickly and at little cost, the majority cwould only be implemented over many years and at differing rates by different systems.

The Codes of Practice should not be performance based, as commercial need will dictate their usefulness. To make it otherwise would undermine their value to the rail industry and could impose unnecessary cost.

The proposed Land Transport Commission or the ARA should play a role in managing and publishing the Codes. However to ensure effective commitment to the Codes the industry itself must also play a key role in development and advocacy of the Codes.

RAC does not support Recommendation 8.3 as the Codes of Practice are not regarded as appropriate for regulation.

6.3 Operating Standards and Procedures OPERATING STANDARDS AND PROCEDURES

As the Report also notes rail systems in Australia are now working co-operatively to remove existing anomalies in operating practices and to provide industry based Codes of Practice via the ARA and the Industry Reference Group under SCOT.

Differences in most standards occur through different commercial needs. RAC opposes the proposition that standards be subject to regulation. Uniformity in infrastructure or safeworking standards may reduce direct costs marginally for operators but at a potentially high cost to track owners and in turn the industry. Each case for uniformity, particularly if being considered retrospectively, needs to be considered on its own financial and safety merits.

Attempting to externally specify or regulate non-safety critical standards, directly encroaches on an organisations right to manage its own business costs and risks. Radio systems have been identified as an example of an inconsistent approach across States that adds to cost and complexity. While this is correct, a practical solution that will have widespread industry support will not be found by government regulation or an enforced uniformity standard on the issue.. In developing any standard there are many safety and commercial considerations to be taken into account and. owners and operators who already have a common incentive to increase efficiency should be allowed to manage such issues with due respect being given to their common and separate needs.

The other factor that weighs against government regulation and enforced uniformity is that the the ongoing development of new technology and operating approaches will make it difficult to keep regulation up to date and uniformity meaningful across the industry.. The result will be that a technical and operating regulation group would be attempting to dictate business policy or perhaps manage by industry consensus; either way would not assist the industry to remain competitive.

National standards should be developed for minimum operating standards for interstate rolling stock specifying safety critical interfaces between track and infrastructure. This would facilitate mutual accreditation across State boundaries. However, under this model where local operating or infrastructure differences exist the track owner would still be able to impose local operating requirements.

6.4 Advancing Regulatory Reform

ADVANCING REGULATORY REFORM

Rail Access Corporation does not support the concept of regulation of safety standards. Standards development, harmonisation or uniformity is, and will continue to be, driven by commercial pressures for improved productivity and market share. Standards regulation is not necessary for safe operation because as discussed there are justified commercial reasons for differences within and across rail systems.

In relation to the regulation options, RAC supports the concept of either a single safety regulator/legislation or consistent state regulation to apply across all rail operation, inter or intrastate. Consistent but separate state legislation in practice is less likely to achieve uniform application because of the wide interpretation usually possible by different parties. However central regulation of the disparate rail systems and operation across Australia does not appear feasible. Most rail operation is intrastate and to be effective the regulator needs to be in touch with the local operation and organisations.

Rail Access Corporation opposes the establishment of a national safety regulator with responsibility for interstate lines. Given that inmany jurisdictions including NSW there is no separation of intrastate and interstate lines, demarcation of management responsibility on such a basis would be impractical.

The report suggests that possibly the Road or Air Transport regulation model could be adopted. The proposal has some merit but fails to recognise the fundamental differences between road and rail. Rail is considerably more complex than road or air in relation to the interaction of train/operator with the infrastructure/owner. The owner both because of its commercial policies and local differences in infrastructure etc will, unlike the Air Transport regulation model have an ongoing need to stipulate local operating conditions. This requirement must be recognised within any regulatory regime.

Rail Access Corporation believes the third option listed in the Productivity Commission's Report is the most viable. The proposed Land Transport Commission should be responsible for developing national safety regulation but states and territories should retain responsibility for legislation and enforcement of such regulation

A Land Transport Commission could also facilitate uniformity, where justified, of technical and operating standards. Its output may be in the form of recommended Codes of Practice for new or substantially modified systems, infrastructure or rolling stock. As noted earlier however, this is not a regulatory role. Currently this role is managed by industry participants through ARA and SCOT via the Industry Reference Group however since the ARA have limited resources and have a focus on promotion of rail to government, it would be better shifted to the proposed Land Transport Commission.

The Corporation supports the Commonwealth Government taking a leadership role in advancing regulatory reform at a national level. This would be a logical extension of the process already underway under SCOT.

7.0 COMPETITIVE NEUTRALITY (REPORT CHAPTER 9) – COMPETITIVE NEUTRALITY

RAC generally endorses the comments and conclusions of the Productivity Commission with respect to section 9.

7.1 Competitive Neutrality Between Rail Operators

RAC notes the Commission's comments that, while untested, there is potential for a lack of neutrality between Government owned and private sector operators.

However, RAC has greater concerns is concerned with two aspects of competitive neutrality between operators that are not specifically addressed in the report. These are::

- oOperators that receive uncontested CSO payments from Government and the potential to use those CSO payments to inappropriately enhance their competitive position; and.

- vVertically integrated operators exercising their effective monopoly over their controlled track sections to enhance their competitive position;.

In regard to CSO's there is a direct competitive neutrality risk in that, in the absence of a contestable process for CSO supported traffics, the information gap between operators and budget sector agencies could potentially result in excess levels of CSO payments. Specifically, CSO's may be paid for traffics that can be commercially supported, thereby allowing the CSO supported operator to win the traffic over a commercial operator. More generally, to the extent that CSO payments meet an operator's joint or common costs, it creates an opportunity for the CSO supported operator to underbid a commercial operator on commercial traffics.

Given that these issues lead directly to increased budgetary outlays, RAC anticipates that the issue will be addressed in the short-term.

The issue of vertical integration is less explicit. The concern here arises from the capacity of a vertically integrated operator to achieve synergies that give it a commercial advantage on contestable traffics.

As previously discussed, under a vertically separated model the market will determine the appropriate extent of horizontal integration above rail. Where the above rail market is distorted by vertical integration there is a risk that a vertically integrated operator will be able to use its effective monopoly to under-write its strategy in contestable markets.

For example, a vertically integrated operator may be able to invest in new locomotives and rolling stock giving it efficiencies in a contestable market in the knowledge that it can cascade older, less efficient equipment into a vertically integrated market. This gives the old equipment a residual value. In contrast, an operator without a captive market will not have the same degree of certainty in its ability to generate a use for older equipment and thereby realise a residual value for that equipment. Consequently it will not be in as strong a position to invest to be competitive in the contestable market. In this way, vertical integration in some markets can distort efficient competition in vertically separated markets.

7.2 Road / Rail Competitive Neutrality

RAC notes the Commission's recognition of the disparity in funding levels between road and rail and the consequent inadequate investment in some parts of the rail network.

The one area that RAC's views vary slightly from those of the Commission is in regard to the potential establishment and role of a Land Transport Commission.

RAC supports the view that road and rail infrastructure management and access charging regimes (for both freight and passenger services) should be further commercialised. An ideal commercial world would see road and rail structured as:

- cCommercial entities with full commercial incentives and constraints, and in particular a requirement to earn a commercial return on capital invested;,

- aAccess charges determined on a commercial basis (ie, profit maximising), subject to a regulatory structure with a floor and combinatorial ceiling test (ie, the structure of the current NSW Rail Access Regime pricing provisions);, and

- aAppropriate taxes and charges levied on a consistent basis across road and rail to recover externalities (air, noise and other forms of pollution, and accident costs not recovered by insurance premiums).

This is the economically correct approach to road and rail competitive neutrality. It would achieve allocative efficiency in both the sense of the total amount of transport consumed relative to the rest of the economy and in the sense of appropriate modal shares between road and rail.

RAC notes that the first and second points are largely in place for rail, especially in NSW, but have not been applied to road[7].

While the structure described is economically efficient, RAC believes that such a structure is unlikely to be acceptable to the community in the short-term, and at best could only be achieved over an extended timeframe.

[7]A particular concern to RAC is that there is evidence that as a result of the averaging methodology adopted by the NRTC for road user charges, heavily loaded B-doubles operating high annual distances (rail's main competition) are paying less than marginal cost and thereby breaching the minimum test of economic efficiency. However, in the absence of a regulated floor test there is no mechanism for the rail industry to formally pursue this issue.

The short-term solution may therefore be to adopt a second-best approach, that is, to attempt to replicate the modal share outcomes that would be achieved with an economically correct approach, while the total quantity of transport continues to be under or (more likely) over consumed.

A second best approach requires considerable intervention in the working of the market. This could be achieved through a number of mechanisms, including through targeting of investment funds and adjustments to the structure of taxes and charges as applied to road and rail. RAC believes that a Land Transport Commission would be well placed to develop and implement a second-best strategy, and in the longer term, a first best strategy.

RAC also sees a role for a Land Transport Commission in facilitating co-ordination across jurisdictions in cases where commercial incentives can not achieve harmonisation on their own. This will generally be in regulatory areas.

PROGRESS IN RAIL REFORM

CHAPTER 10: SOCIAL DIMENSIONS

8.0 8.0 SOCIAL DIMENSIONS (REPORT CHAPTER 10)

8.0 SOCIAL DIMENSIONS (REPORT CHAPTER 10)

87.1 Overview of RAC's response

- RAC generally supports the comments and findings contained in Chapter 10 of the Report. However, the export coal adjustment component is not and has never been used by RAC to cross-subsidise loss making operations as suggested by the NSW Mineral's Council.

- *RAC supports the funding of non-commercial rail services through a purchaser-provider model which provides market based incentives for the service provider to control costs and raise utilisation levels.*

- *The above rail markets must be allowed to compete for CSOs provided within a competitive market environment in order to avoid unfair competitive advantage by any one market player.*

- *RAC agrees with the Report's findings that the real impact of job loss within rail on regional development has not yet been properly assessed or understood.*

- RAC supports the Report's finding that increased productivity is the optimal long term answer to providing sustainable job growth and security in the rail industry. RAC supports any labour adjustment process being actively managed through job retraining and relocation assistance strategies.

- RAC sees industry players such as RAC, RSA and relevant unions as the appropriate managers of any labour adjustment process in NSW.

87.2 RAC's Response to the Report

8.2.1 Provision of non-commercial services

RAC agrees with the Report's view that a purchaser-provider model needs to be established for the provision of non-commercial services. The principles underlying RAC's 7-year CSO contract with the NSW Government should be adopted as a model for the provision of non-commercial services in NSW. The need for clarity and certainty in the provision of non-commercial services for service providers is particularly important:

- *given the extent to which the NSW rail system is dependant upon CSO payments; and*

- *if the draft Report's proposal to franchise urban rail is realised as franchisees who are operating for a commercial return will need certainty about the provision of non-commercial services.*

8.2.2 The current provision of non-commercial services in NSW

Non-commercial services constitute a significant portion of the total rail services in New South Wales (see attached map in Appendix 1) In NSW the essential infrastructure network, other than the commercial Hunter Valley coal network, is reliant on Government CSO funding for continued operation.

The State Rail Authority's (SRA) operations are funded through a CSO. SRA funding for the Sydney electrified network accounts for approximately 50% of RAC's gross revenue. An additional 26% of RAC's revenue is received directly from the Government to keep non-commercial country railway lines operational. So in total 76% of RAC revenue is CSO dependent.

In 1997 the Corporation secured a seven year CSO contract worth $1.168 billion with the NSW Government for "below rail" maintenance for under-utilised lines. This excludes the commercial Hunter Valley Coal Network and the Sydney electrified network. The contract is consistent with the Industry Commission's view (as contained in their 1991 report 'Rail Transport') on the recommended criteria for the provision of non-commercial services. The Industry Commission recommended that:

- *if governments require railways to provide community services, the conditions of provisions should be set out in contracts and should include the pre-determined fees to be paid to the railways;.*

- *that community service contracts between governments and railways should be as specific as possible identifying exactly what particular market segments or lines are to be explicitly funded as community services. The contracts should also include criteria for evaluation of the performance of the rail authority in meeting each particular service; and.*

- *that payments made to the railways under any community service contracts should be charged against the appropriate expenditure category.*

Under the terms of the 7-year contract RAC guarantees that in the normal course of events, it will maintain each of the nominated country lines in operational status for the life of the contract. The contract also provides that the nominal value of CSO support to each line sector declines steadily each year to deliver the Government a total nominal saving of 9% equating to a real saving of 22% (assuming 2.5% inflation each year).

If RAC achieves cost savings or revenue growth which produces less profit than the programmed reduction of CSO payments it sustains a loss. Conversely, if RAC *achieves greater cost savings and/or revenue growth, any profit earned with the aid of the CSO contract is retained by RAC. Securing the contract was a vital step in achieving stability in the rail reform process, transparency of costs and certainty of funding flows.*

In summary the desirable features of the CSO contract model incorporated in the 7-year CSO contract are the:

1. service provider (RAC) is contractually committed to maintaining the specified line sectors to an agreed service potential;

2. agreed service potential for each line sector reflects its traffic mix and current condition;

3. contract provides the service provider with incentives to control costs and increase utilisation;.

4. *contract allows for the purchaser to maintain control over its non-commercial priorities by allowing it to remove line sectors from the contract. If this occurs RAC is then entitled to stop carrying out its maintenance obligations on the line sector and avoid any further costs from being incurred; and.*

5. *contract provides penalties to be imposed where the service provider fails to maintain the agreed service potential.*

The present CSO line sector approach is the model preferred by all parties in NSW because it recognises that rural rail freight usage is insufficient in most sectors to meet the fixed common costs of providing access. It allows RAC to charge train operators, particularly freight operators, affordable access fees which make a contribution to fixed costs. Other previous funding approaches did not address this issue and attempted to transfer the infrastructure shortfall to freight rates or to passenger fares with all the attendant distortions.

8.2.3 Other Desirable Features

CSO contracts with rail operators should be awarded on a competitive basis. This is consistent with the objective of reform to promote the best value for money service within a competitive framework. Competitively awarding CSO contracts also eliminates the potential for any one operator to leverage an unfair advantage over other operators by using CSO revenue to support their business while undercutting market rates.

It is recommended that CSO contracts for the State Rail Authority should meet the performance based objectives of the purchaser-provider model. In order to ensure mutual certainty and transparency for both the service provider and the purchaser, the SRA CSO contract should have specific market based outcome targets. That is *payments should be based on the performance of these outcome targets This will allow the RAC to make infrastructure investment decisions which reflect the market needs of the SRA.*

8.2.34 Employment

In the pre-reform era the underlying causes of job loss were technological developments and rail's inefficiencies. Yet despite the causes being identified nothing was done to manage the issue. Job losses occurred in pre-reform days in an unmanaged free fall with no specific objectives or outcomes in mind. If this had continued to happen, unchecked, the impact for the rail industry in the long term would have been extremely detrimental. The rail industry would have ended up with either a significant oversupply or an undersupply of labour in diverse areas of service. Resultant inefficiencies in cost and productivity would have disabled the industry from being a competitive force within the transport sector.

In contrast, under the rail reform process job losses have occurred as a result of specific productivity and efficiency gains measures. Industry is aware of the areas it needs to target in order to increase productivity and efficiency and is making conscious decisions about labour retention rates. This offers a level of certainty and stability on labour issues. More importantly though creating a competitive industry, the reform process will ensure labour stability and growth for the rail industry.

8.2.45 Employment Impacts in Regional Australia

There has been a strong debate between rail industry stakeholders about the merits of striving for labour market efficiencies through the reform process. The draft Report identifies concerns about job security and negative impacts on regional developments as two of the main charges levelled against rail reform.

Rail services to rural and regional areas clearly play a role in supporting local economies, however, the extent and criticality of this role has not, to date, been defined. It would be absurd in the absence of such information to lay all or even primary blame for negative downturns in rural and regional economies at rail's door. RAC supports the Productivity Commission's view that any assessment of the impact of labour market reductions in rail on regional Australia must occur within a broader analysis of the impact of other socio-economic issues which also affect those economies.

RAC agrees with the Commission's comment that labour adjustments in the rail industry should be effectively managed. RAC and other agencies within the rail industry who have legislative responsibility for service outcomes and who are affected by labour adjustments are the appropriate managers of this process. Industry players are best placed to negotiate and agree on optimal industry-based outcomes such as retraining, and redundancy to mitigate the impact of any job losses.