SUBMISSION
TO THE PRODUCTIVITY COMMISSION REVIEW OF RAIL

Rail and rail policy

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1. Introduction

I have been involved in a number of rail access issues in recent years. In each case the railway concerned was not making a commercial return on the investment involved. The reason for this failure was that, with the range of prices being charged, insufficient customers were willing to pay to use the rail services to provide an adequate revenue stream to generate a commercial return.

There are a number of ways of interpreting this outcome.

2. Inadequate revenues

The first possibility is that the revenues were too low because the prices were too low. Such an outcome might have occurred because managers were not very competent at stimulating demand, setting prices and/or extracting rents where they were available, or because managers were not attempting to make commercial returns. Each of these reflects on the quality and motivation of management and the correct way to address such concerns lies with the owners of the enterprise. Corporatisation, privatisation or some other scheme which provided managers with strong incentives to pursue revenue more actively would/should resolve the issue. It would not be appropriate to attempt to provide a regulatory or structural solution. Call this the **poor incentives** case.

Alternatively prices might be set too low by regulation or by politically-sanctioned custom. It is possible that this has occurred but I have not come across such a case. Call this the **regulated prices** case.

Another alternative on the revenue side is that the rail price cannot rise because of the competitive pressure imposed by road or even sea transport. Many rail operators have suggested that there is strong inter-modal competition in freight markets and that this effectively limits their capacity to raise prices. Call this the **inter-modal competition** case.

The final major alternative is that the revenues indicate the private return on investment but do not adequately capture the social returns on the project. If this were the case the correct policy position would be to evaluate the community service obligation involved and to include it with revenues when attempting to decide if revenues are inadequate. This is the **CSO** case.

3. High costs

The other broad alternative is that the costs involved in the rail system are too high.

This in turn can mean a number of different things. One is that owners have over-invested in railways so that there is no realistic chance of their ever earning a commercial (or social) return on investment. The only sensible approach if this were the case would be to write off the inappropriate investment. Governments may also have got into this position due to unforseen reductions in population or industry in some areas that have stranded their investments. This is the **misplaced investment** option.

The are other alternative explanations for firms carrying excessive investment but they mainly centre on strategic decisions which do not seem to apply in the case of rail.

It is far more often argued with rail that investment has been inadequate.

4. Interpretation

The cases I have been involved with have involved long distance rail routes. In general the material I have worked with suggests that the principal reasons the lines do not earn an adequate return are because of poor managerial incentives and significant inter-modal competition.

This is not to argue that the other factors have not played a part. The transactions costs of freight companies having to deal with a number of different operators, with poor quality service, and of failures to meet timetables have all been issues but not the dominant concerns.

On almost all routes in Australia, rail faces competition from other modes. On many it carries considerably less than half the freight volume. The small number of exceptions includes the route from Adelaide to Perth, and some routes that carry minerals such as coal.

5. Policy

The broad thrust of policy seems to have been towards creating a unified national system, towards structural separation, and towards developing third party access conditions for rail. In my judgement most of this has been misconceived.

If rail faces strong competition from road, so strong that it does not earn a commercial return, than we should not be treating rail as a natural monopoly. It may involve the technology of natural monopoly but there is no scope for this to provide for monopoly

exploitation because of the inter-modal competition. The correct policy position at the first level would thus seems to be to remove regulation, and to remove third party access requirements, since these will not produce efficiency gains.

Even in the case of coal and other mineral lines on which there may be some degree of monopoly power, the prices concerned are set on the international market which again provides a check on the ability of the rail operators to extract monopoly rents.

The best solution to the managerial and incentive problems seems to lie in privatisation or in (very hands-off) corporatisation.

The new private owners, or the corporatised operators, have an incentive to arrive at solutions that minimise the transactions costs to their customers in order to increase revenues and profitability.

6. Related issues

If we were to adopt such an approach then there is no need for structural separation. The basic rationale for structural separation is that some parts of the industry are competitive and other natural monopolistic. When the firm is dis-integrated vertically competitive forces then act as the discipline on competitive segments and regulation limits rent extraction in the monopoly stage.

In the case of a loss making industry such as rail, subject to intense price competition from a competing mode, then there is no reason to vertically separate the industry. Even further there is no reason to impose regulatory structure of limit monopoly abuse. That will be achieved by the inter-modal competition. This leads to the more substantial conclusion that we need not be concerned about the formation of a rail monopoly since the potential for the abuse of monopoly power is sharply limited.

The other policy risk, of a lazy monopolist that fails to make the best use of its infrastructure, is best addressed by corporatisation or by privatisation (in which case it becomes the private owner's risk).

The best outcome would be achieved if the price of road services were set in such a way that it takes full and appropriate account of road costs and any external benefits and costs. Once the price is set this way, then allowing free competition between road and rail is likely to improve policy outcomes.