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QUEENSLAND RAIL

Mr John Cosgrove
Presiding Commissioner
Industry Commission
LB2 Collins Street East
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Dear Mr Cosgrove

Re: Industry Commission Inquiry into the Black Coal Industry

I was interested to review the Commission's draft report into the Australian Black Coal Industry and noted, with particular interest, the content of Chapter 7 - Coal Rail Transport. There are a number of issues in this chapter that I would like to comment on prior to the finalisation of the report.

Structure of Rail Authorities

The draft report reviews some of the issues of vertical separation of rail, concluding with a recommendation that the Queensland Government undertake the formal separation of above and below track facilities into independent organisations. It also indicates the Commission's intention to seek participants views on the advantages and costs of such a separation and on appropriate structure and ownership of current government providers of rail infrastructure and freight service.

Queensland Rail has elsewhere submitted its views on vertical integration and the separation of rail organisations. Attached is a review of the issue submitted by Queensland Rail to the House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform, for their Inquiry into the Role of Rail in the National Transport Network. This submission argued that:

- Powerful competitive incentives can be achieved through means other than vertical separation;

- Overseas experience indicates that vertical separation has not generally lead to above rail competition and other factors are more important in determining potential for multiple operators;

- Infrastructure and operations interdependencies are very important, as recognised and discussed in the draft report;

- The costs of separation are considerable and have been estimated by a Mercer/Booz-Allen study for Queensland Rail to be in the order of $30 to $50 million, not inclusive of major costs associated with desegregation of information systems;

- Other costs of separation include reduction of market responsiveness of infrastructure investment, loss of economies of scope and size, increased safety risk, and costs associated with staff and community reaction to separation.

Since the costs of separation are significant, the benefits of separation should be established as significant and unequivocal before a policy of mandated separation of ownership can be justified.

Under these circumstances the regulatory approach adopted in Queensland should be given an opportunity to demonstrate independent and transparent delivery of rail infrastructure within a structure of vertical integration.

Introducing Competition into Rail Freight

The draft report discusses the current status of Queensland's third party access regime with respect to rail. Since the submissions to the Industry Commission's inquiry were first sought, there have been a number of additional developments in Queensland's third party access regime.

The Queensland third party access regime provides for services to be declared by way of a regulation under the Queensland Competition Authority Act. On 26 March, a regulation was made under this Act declaring the use of all rail transport infrastructure owned by Queensland Rail for the purpose of providing transportation by rail (with the exception of interstate services).

On 25 April, the Government announced the removal of the exemption under the Queensland Competition Authority Act for access to coal carrying services. The removal of this exemption is fully supported by Queensland Rail.

The Queensland Government is of the view that the Queensland third party access regime constitutes an effective access regime in accordance with the Competition Principles Agreement. As such, the Queensland Government will soon be submitting the access regime with respect to rail services to the National Competition Council for certification.

Price Setting for Rail Access

The discussion on asset valuation and rate of return correctly identifies that there is a need to match the asset valuation approach and rate of return measurement in order to avoid systematic over or under pricing.

The report then goes on to note that Queensland Rail uses a deprival value (a current cost asset valuation methodology) and a nominal rate of return target, implying that this results in Queensland Rail systematically over pricing access. However, this implication is incorrect as it does not fully recognise the methodology used for measuring Queensland Rail's performance against the rate of return target.

Queensland Rail's performance is measured in accordance with its economic rate of return. The economic rate of return approach recognises both "profit" and "capital gain" as economic income. Therefore, asset appreciation (recognising the impact of inflation) is added to net earnings in order to assess Queensland Rail's performance against its nominal rate of return target. This approach is equivalent to measuring earnings (excluding asset appreciation) against a real rate of return target. Therefore, contrary to the claim by the Queensland Mining Council, QR is only compensated once for the effects on asset values of inflation.

Yours faithfully

Vince O'Rourke
Chief Executive

26 May 1998

ATTACHMENT

INTEGRATION OF RAILWAYS

1.1 The Issue

There is increasing polarisation worldwide between two very different approaches to running railways:

- the integrated ’one organisation’ approach of the commercially successful railways of the USA, Canada and New Zealand; and
- the fragmented institutional separation of infrastructure and operations being pursued by the interstate railways of Australia, the UK and some Scandinavian countries.

Industry history indicates that the separation of operational control from infrastructure control evolves and emerges naturally in some circumstances. US integrated railways provide commercial access to operators traversing their tracks as part of a larger network. Moreover examples of commercially successful railways can be found within both vertically integrated and vertically separated structures.

The issue then is not whether infrastructure and operations should be separated. The crux is understanding to what extent and under what circumstances control and ownership should be separated, and understanding when vertical separation of ownership should be mandated by Government.

Queensland Rail’s submission to the Neville enquiry asserted that "there are advantages to an integrated structure, including factors of optimal size, economic value, lower transaction costs and efficiencies, as well as safety. Vertical integration best accommodates the high level of interdependencies that exist between infrastructure and operations."

Subsequent to Neville Enquiry sittings in Brisbane on 19 February 1998, this follow up paper expands on the advantages of integrated railways.

1.2 What drives separation?

There appears to be at least three main lines of thought underlying the appeal of vertical separation:

- Firstly, dissatisfaction with historical railway business performance can predispose Government to a structural solution that provides a one off windfall to Treasury coffers and helps to dispose of non performing debts.
- Secondly, there are analogies with other transport modes. Shipping owners and operators generally do not own ports and port facilities. Road transport operators certainly do not own or control roads. Airlines do not own airports or flight paths. Why should rail be any different? The short answer is that when rail infrastructure uses more than a small percentage of its capacity it requires central

control to achieve safety and efficiency. The longer answer is developed within this paper.

- Thirdly, there is the agenda of increasing competition and the influence of National Competition Policy. By separating out the natural monopoly element of rail infrastructure and encouraging operator competition through commercial access arrangements, efficiency can be maximised through competition. Without infrastructure separation it is presumed that the carrier controlling the infrastructure will discriminate against competitors and inhibit competition. The limitations of this perspective are discussed below.

1.3 Vertical Separation and Competition

The main driver of infrastructure separation in Australia appears to have been National Competition Policy. However the link between effective competition and vertical separation is less than clear cut.

Vertical separation as a means of competition overlooks the importance of intermodal competition as a market based mechanism for providing efficiency incentives. It also overlooks that there are a range of structural options and tools available for providing infrastructure access and intramodal competition where intermodal competition is weak. One of these tools is mandated access. Powerful competitive incentives can be introduced through the threat of third party access, and this can be intensified through an appropriate regulatory framework and the threat or reality of mandated access.

Moreover countries that have separated their infrastructure have not achieved competition on the rails to date. Sweden's annual infrastructure investment has increased by more than 300% since separation in an attempt to create a level playing field with roads, but there is no intra-rail competition to date. There is virtually no competition on the rails in the UK.

Factors other than vertical structure appear to be far more important in determining the capacity to generate intramodal competition - factors such as traffic density and point to point flows (ie the market potential for multiple operators).

Queensland has developed a model where an integrated GOC railway has an enhanced separation of control, but without the separation of ownership and with consequent retention of most of the advantages of integration. The advent of the Queensland Competition Authority has provided a framework that helps to ensure that actual and potential third party rail operators are treated equitably. It also helps to ensure that productive efficiencies are extracted from the creation of a competitive environment. The performance of Queensland's approach over the next few years will be critical to an evaluation of the advantages and disadvantages of integration.

It is particularly important to recognise that probably the most significant factor contributing to rail inefficiencies is the tendency for the rail industry to be bound up in

certain political processes. These have objectives other than pure transport outcomes - ie social welfare, employment and regional development objectives. Recent developments between the NSW Government, Rail Access Corporation and Rail Services Authority, serve to highlight that infrastructure separation is not a solution to this problem.

Undue emphasis on the 'solution' of vertical separation is based on a mix-diagnosis of the problem. The involvement of private capital may well bring to bear forces to establish arms length relationships with government in regard to efficiency related decisions. Infrastructure separation of itself demonstrably does not achieve this.

1.4 Infrastructure and operations interdependencies

An integrated railway can most effectively make the infrastructure and operational trade-offs necessary to make optimal investment decisions and provide the best possible service. The physics and engineering of steel wheel and steel rails do not correspond to organisational boundaries. Examples of these interactions include:

- Investing in infrastructure improvement needs to be traded off against other strategies such as investment in rollingstock, changing train configurations, and changing operational limits (axle load, speed). Decision making in regard to infrastructure investment and rolling stock operations are therefore closely interconnected.
- Rollingstock maintenance strategies need to be traded off against infrastructure maintenance and replacement strategies. For example an operator who does not maintain the infrastructure will not be as vigilant in servicing 'square wheels'. Infrastructure maintenance costs will be adversely impacted.
- Technical development is heavily integrated between train and track.
- Coordination of track maintenance and operations may not be managed efficiently when these responsibilities are separated.

These kind of issues can indeed be managed through complex contracts with monitoring and performance regimes. But it is a complicated and expensive business to do so.

1.5 Costs of infrastructure separation

Overseas experience shows that separation of railway corporations result in considerable legal and administrative costs. For the kind of reasons discussed above, when ownership is separated, the management based coordination that is available within an integrated company must be replaced by complex and expensive contractual agreements.

Moreover, introduction of new institutions - the result of railway separation - has been shown to be inevitably accompanied by duplication of managers and support staff.

This leads to significant increases in Government resources to manage the complexity that has been created.

An independent study by Mercer Management Consulting and Booz-Allen & Hamilton stated: "separating QR's infrastructure from operations and setting up a track authority would not be as complex as the establishment of Railtrack and the cost of UK privatisation (total costs of over $300 million) but we would expect costs of the order of $30 to $50 million".

Further costs (probably not captured in the Mercer/Booz-Allen study) relate to information systems. The strategic direction of many transport organisations, including Queensland Rail, is towards logistics management and involvement in the whole supply and distribution chain. This has entailed heavy investment in global and integrated information systems. Breaking up QR at this point would result in massive losses due to abandoning such systems and/or having to redevelop systems at additional cost. Indeed the move towards logistics management is about industry integration and desegregation goes against this trend.

1.6 Reduction of market responsiveness of infrastructure investment

A vertically integrated railway will make market driven maintenance and investment decisions. A separate infrastructure company may be removed from market pressures and consequently may over-invest or under-invest. It could be argued that this has occurred with Swedish rail infrastructure investment levels.

1.7 Economies of scope and size

Railways tend to work better as large entities, as evidenced by the US experience and by recent UK mergers. This reflects an industry characterised by high fixed costs and high transaction costs.

No analysis has been done on optimal size in Queensland. However the Mercer Management/Booz-Allen & Hamilton consultancy, which was carried out as part of the recent Queensland State Government Corporatisation Review Taskforce, made some relevant comments.

The report argued that the relationship between total costs of access with separation compared to total costs of access with an integrated QR, depends on the number of new entrants when barriers to entry are removed. In other words, the report argued that if changes in the regulatory environment fail to result in market support of multiple operators, then the economies of scope and size should be accepted and the costs of infrastructure separation are likely to exceed the benefits.

This contingent and cautious approach to vertical separation seems likely to underpin Queensland policy development for the foreseeable future.

1.8 Safety

Safety is essentially about reducing risks by reducing variation via standardisation. Yet creating multiple suppliers with different cultures and procedures has two adverse effects:

- increased risks of safety failures
- increased costs due to the complexity required to conform to one standard.

Moreover, translating government policies into standardised safety systems requires considerable engineering and operational expertise to convert performance standards into technical standards. Such expertise best resides in large organisations that span infrastructure and rollingstock competencies.

1.9 Staff and community reaction

Queensland Rail staff reaction to separation was judged likely to be antagonistic, with the potential for widespread instability and industrial unrest. Staff and community reaction could have paralleled that of the branch line closures proposed in the early 1990s.

The social systems and cultural aspects of vertical separation are not well understood and the risks are high. Collective attention could well be diverted from incremental improvement and consumed by a combination of industrial/political conflict and the need to progress complicated realignment of structures and systems.

1.10 Conclusion

Queensland’s retention of an integrated structure may be out of step with Australian national trends. But it’s not out of step with the more pluralist international trends. It remains unclear under what circumstances vertical separation results in increased competition or efficiency. However since the costs of separation are significant, the benefits of separation should be established as significant and unequivocal before a policy of mandated separation of ownership can be justified.