

QUEENSLAND RAIL



Submission to Productivity Commission Inquiry

Review of National Competition Policy Arrangements

August 2004

Table of Contents

Overview

1	Introduction.....	1
2	Reform Experience.....	2
2.1	National Competition Policy.....	3
2.1.1	NCP Objective	4
3.1.2	Communication	6
3.1.3	Cost of Cynicism	7
2.2	Regulation.....	8
2.3	Competition.....	10
2.4	Private Sector	13
3	Key Policy Dilemmas.....	15
3.1	Interfaces.....	19
3.2	Role of Government	20
3.3	Performance Assessment	21
3.4	Market Power.....	23
4	Conclusion.....	26

[Attachment](#)

Overview

The essence of National Competition Policy (NCP) has been about removing constraints and promoting flexibility. Australia is certainly more prosperous for having done so. But in the process, we have developed a belief that further progress is simply a matter of pulling the same old levers a little harder. This belief risks undoing all our positive achievements, as it overlooks the fact that real efficiency does not fit any of the policy “boxes” on offer.

Thus, QR does not have a literal answer for the Productivity Commission on what needs to change with NCP, because what needs to change is the expectation that our goal can be achieved through mechanistic options like greater competition, sale of public assets or more intrusive regulation.

Economic reform is centred on better managing our resources. There is no argument with the sense of this objective. What must also be realised, however, is that decisions regarding resource allocation are made by people, exercising their unique skills and capabilities. Ultimately, NCP is about allowing the right person doing the right job to make the right decision, so that the community as a whole is made better off.

Competition and regulation has helped QR and many others ask questions about how things can be done better and who should do them. But NCP has also added considerable rigidity to the personal interfaces that are so crucial in providing the flow of sound advice, both within an organisation and between it and its customers. Regulation isolates by actively discouraging the discretion needed to make sound choices. When it is pre-emptive, it restricts proper commercial judgements by giving the mistaken impression that expertise can be second-guessed. While regulating after the event means it misses the behaviours it claims to be about rectifying.

In a similar way, competition breaks relationships down in order to make transparent the drivers of performance. Once segmented, the person/business unit/corporation has a natural inclination to concentrate on their individual part at the expense of the whole. Such competition-inspired fragmentation is in direct conflict with policy and commercial efforts to achieve efficiencies through integration of physical and non-physical networks.

An unintended impact of micro-economic reform has therefore been the diminution of trust. NCP has excelled in making us all stronger individuals, but the “glue” that holds the team together has been severely diluted along the way. The intent was for Australia to develop a champion economic team. The reality is we are achieving a doubtful association of individual champions who see teamwork as weak because it threatens identity and tolerates poor performance.

QR believes that these issues are in need of frank and open discussion. Raising them in a policy sense, however, has met with limited success due to the institutionalised mistrust that now exists.

NCP was about removing barriers. Yet the current policy debate itself suffers from such constraints. Our commentary on economic policy is usually taken with a grain of salt because others have already put QR in the wrong box – a publicly-owned, vertically-integrated railway. Those that have advocated NCP in the past appear

unwilling to address the cost of the cynicism associated with economic reform because it implies that the policy is flawed.

NCP can only be a failure if we fail to acknowledge its limitations. Chief among these is the fact that the objective of reform is unreservedly vague.

Despite its name, NCP means absolutely nothing in particular, as true efficiency, while being a generalised concept, requires consideration of a specific set of circumstances that cannot be pre-empted. Questions like “Should infrastructure be separate from operations?” can be posed, so long as it is realised there is no predetermined answer. In some cases, this has not been practiced and NCP has been used as a front for making radical changes for the wrong reasons.

Furthermore, the more dynamic the economy becomes from less government intervention, the more complex this context becomes and the greater the value of individual expertise in determining what is best. This means that we must be less distrusting if we are to account for where the market is headed, make the right policy/commercial judgements and provide a basis for why initiatives like NCP were embraced in the first place.

Ironically, this process is effectively confirming the elusiveness of the NCP objective.

Dealing with these challenges will require leadership. We need to be candid about the vagueness of our objective and the cost of cynicism, without being protective of the merits of the economic policies that have delivered Australia significant prosperity. QR believes that many unnecessarily conclude that any concerns raised over NCP, competition or regulation means support for the opposite. This is not the case. QR is not ticking an anti-NCP box. It wishes to elevate the debate beyond the idea that legislation or a particular policy tool can mandate what is needed.

Governments and the community must be advised that we are well past being able to measure our policy successes. Formal requirements and bold promises will become increasingly counter-productive – pre-empting what cannot be pre-empted only demonstrates a lack of understanding of the true intent of reform. This conundrum is a legacy of the fact that the supporting economic theory incorporates a “leap of faith”. There is no way to prove that efficiency is a worthwhile goal because it cannot be captured or defined.

Accordingly, the resistance to NCP is not necessarily about vested interests. It may equally be concerned with having governments and policy-makers acknowledge what they claim they already believe: policy can remove restrictions to our prosperity, but it cannot force the most vital dimension of efficiency – the artistic value add provided by people. Much of the present policy effort actively contravenes this principle, causing significant frustration by attempting to achieve what can never be delivered upon.

QR believes the way forward is to recognise that NCP, while being a necessary step, has also undermined our common purpose and thus the teamwork that is an undeniable part of efficiency. An acknowledgement of such should provide a basis for understanding how to take the next step in the process of developing a truly sustainable economic policy framework.

1 Introduction

The National Competition Policy (NCP) has had a profound and, in an overall sense, positive impact on the Australian economy. Queensland Rail (QR) welcomes the Federal Government's decision to ask the Productivity Commission to review the NCP arrangements.

As outlined in this submission, QR has had first-hand experience with the micro-economic reform agenda and hopes to provide some important insights for the Commission. We believe it is imperative that consideration be given to high-level strategic matters in a consultative and open fashion. Governments, policy-makers and bodies such as the Commission need to regularly return to the "big picture" questions to ensure the momentum for change is appropriately directed. History has shown how easy it is to lose sight of goals and objectives, especially in a modern economy which is developing at a rapid pace.

As discussed throughout the submission, QR firmly believes that the change has been for the better and that momentum for addressing remaining issues (eg imbalance in access and pricing conditions between rail and road) must continue. The key issue for QR is how this is to be done. There are no simple policy solutions like increasing competition, giving greater powers to regulators or selling off more public assets. With the easy gains now gone, such thinking is at risk of becoming part of the problem.

The structure of the submission is as follows:

- Reform Experience – outlines QR's experience with the NCP process and some of the major challenges that have emerged;
- Key Policy Dilemmas – details the key policy issues that should be considered by the Commission; and
- Conclusion – provides concluding comments and acknowledgements which QR believes would lead to improvements in the implementation of NCP.

Officers from QR are available to discuss further any of the comments made in the submission.

This submission is provided on the basis that QR is a statutory Government Owned Corporation with a commercial charter and an independent Board of Directors. The views expressed are thus QR's and do not necessarily reflect those of the Queensland Government or any of its agencies.

2 Reform Experience

QR is one of the longest operating transport providers in Australia. As an integrated organisation responsible for network and train services, it has had to confront the growing expectations and requirements relating to economic reform. The NCP agenda has been at times an onerous undertaking, with unforeseen issues and challenges. The strong historical relationship with government has also provided QR with a unique insight into the difficult issues and trade-offs Ministers and policy-makers must make in respect of economic policy and broader community values.

Based on QR's experience, Australia has had a "mixed" report-card on the market reforms of the last twenty years. NCP has been a tremendous success in having business – including QR – look harder at its efficiency. At the same time, however, change has also unearthed many difficult issues and dilemmas.

The supporting principle of *laissez faire* has, in a contradictory manner, also been accompanied by extensive economic re-regulation. Barriers to entry have been removed and restrictive regulations repealed only to be replaced with "market-friendly" controls designed to promote efficiency through addressing externalities and other market distortions. While a conceptual case can be made for such controls, implementation can lead to a confusing situation that mismatches theory with practice. For example, governments have attempted to find the right policy balance by simultaneously liberating and constraining the positive aspects of market forces.

The major concern with NCP at present is that there is a sense that more needs to be done but no-one has an answer for how we should take this next step. As noted by the recently formed National Transport Commission (NTC):¹

There is no longer a list of relatively simple, well-defined problems to address, as was the case when the National Road Transport Commission [the NTC's predecessor] was established. Solutions to the problems Australia faces now in relation to land transport are less obvious.

While there are potential new areas for governments to take NCP-type initiatives (eg water, services), it is important that there first be adequate recognition that the initial phase of NCP reform has suffered significantly diminished marginal policy returns, especially in respect of infrastructure sectors like rail and energy. As outlined below, the high-level elements of NCP have been necessary to achieve efficiency, but the policy as it is currently being implemented does not appear to be sufficient.

An unwillingness to question if something fundamental needs to be re-considered in respect of NCP is likely to undermine the gains that have already been made.

QR's experience with the key aspects of NCP and related initiatives is discussed below.

¹ National Transport Commission (2004), "Strategic Directions in 2005-06 to 2007-08", Industry Consultation Paper.

2.1 National Competition Policy

It makes sense to maximise the value of the community's resource by removing barriers to the free flow of goods and services. It is commonsensical:²

Ultimately, the ability of the economy to grow, to provide jobs and an improved standard of living, depends upon how well the productive potential of the economy is employed and enhanced.

In many respects the package [of NCP reforms] is simply a statement of common sense. It is not a radical notion that business should not be permitted to engage in anti-competitive conduct. It is not a radical notion that in reviewing legislation or market structures, due consideration should be given to opportunities to enhance efficiency through competition. But the great step forward made by this package is that it sets out these statements of common sense for all to see; it creates new institutions better able to encourage businesses and governments to act in accordance with these statements of common sense; and the resulting principles will be applied to all Australian businesses regardless of ownership or legal form.

When NCP was introduced, however, there were many practical, common sense questions that arose. The core reform concept of competitive neutrality was put to stakeholders in a metaphoric way – the “level playing field” – but it was still unclear on how it was to be achieved. At that stage, there was very little integration of the theory with reality, as there was no practical experience to draw upon.

QR, along with others no doubt, asked questions along the following lines:

- Did NCP mean competition *per se*;
- Do governments have to sell their trading assets to the private sector;
- Will QR and other vertically-integrated entities have to separate infrastructure from services; and
- Are regulators going to assume responsibility for making commercial decisions?

All these questions were answered with an emphatic “No”.

QR was informed that in spite of its name, NCP meant nothing in particular, as the ultimate objective of efficiency, while being a generalised concept, can only really be applied on a case-by-case basis. Competition and regulation are only means for improving community welfare by using resources more efficiently – they are not the ends.

A number of difficulties immediately arose.³ First, if competition is only a means, why then does it dominate the policy environment? Why is it not possible to implement a purely efficiency-based policy instead of “second-best” competition? If competition is not sufficient, what then fills this policy gap? Second, how does one define the policy

² Crowley, Sen The Hon R.A. (1995), Competition Policy Reform Bill:1995, Second Reading, *Hansard*, p. 2434.

³ While these difficulties were immediate, it has taken QR some time to understand and eventually articulate their nature.

objective if there is no first-best solution? How does one measure welfare and establish goals?

Issues related to these difficult questions are discussed below.

2.1.1 NCP Objective

The Commission has asked in its Issues Paper (p. 6) if “NCP outcomes have been consistent with their stated objectives (that is, to raise the competitiveness and flexibility of the economy and improve living standards)”.

What is the stated objective of NCP? If it is efficiency, how do we know if we have achieved it? What is flexibility? What is competitiveness? Is commonsense subject to a formal process that can adequately capture and express it? Or is it, paradoxically, something that cannot be rationally explained even though it is assumed to be commonly known?⁴

The Commission has suggested that there is a rational, scientific explanation for the positive impacts of NCP, and that it is not a “miracle”.⁵ Rather, Australia’s improved performance was about “simply removing the lead in our saddlebags”.

The removal of barriers and constraints are a pre-condition for better performance, but this is not the cause – it still does not explain the detailed ins-and-outs of what took place to enable this to happen. There is no demonstrable cause-and-effect link between less “lead” and prosperity. As with good infrastructure management, the process of people making decisions in order to achieve efficient outcomes “cannot be accounted for as produced by any of the known forces of nature”. This is the essence of the “theory” that supports market-based policies such as NCP. If the process of economic activity and growth were a complete science, then it would also be possible to adopt a formula for efficiency.

NCP and related policies could be said to have an objective such of as “flexibility and competitiveness”, provided these goals are not required to be defined or measured against. This is the case because the objective involves our resources being put to their best use. What “best” actually is, will always require an element of judgement. As with good commercial practice, sound policy incorporates an inexplicable component that is entirely consistent with the “invisible hand” of free-market economics. In this way, NCP must be as flexible and competitive as the economy it seeks to reform.

After many years of expose to the regime, QR believes the real objective of NCP is for better teamwork between the most important resource we have: people. The notion of better resource use does not make any sense without the value add provided by expert judgement. The physical resources are only relevant insofar as they are affected by decisions made by people who can understand what is best. NCP is not about competition; it is seeking to promote teamwork by taking away barriers preventing the right people doing the right job in the interests of the wider group.

⁴ Note the consistency of this proposition with comments made by Senator Brandis on the issue of predatory pricing: “One of the problems we are trying to grapple with is that this is not a defined term but everybody throws it around as if we all knew what it meant” (Senate Hansard, 31 October 2003, see footnote 12).

⁵ Banks, G. (2003), “Australia’s economic ‘miracle’”, National Institute of Economics and Business, ANU, Canberra, 1 August.

This team outcome is the gap between true efficiency and “policy boxes” such as competition and regulation. QR’s experience with the rail industry provides a case study for how a reliance on pre-determined solutions to close this gap can be counter-productive.⁶

The rigidity of pre-NCP arrangements often imposed unnecessary restrictions on the value of individual skills and capabilities. At the same time, however, these more formal structures also “protected” a sense of purpose and unity. The process of breaking-down the old networks can thus conflict with these important team attributes. As discussed later, competition and regulation tend to focus us on the parts rather than the whole. They also promote a more systematic approach to business that places an emphasis on what can be formally quantified (eg profits, costs) over that which cannot (eg sense of community, service satisfaction).⁷

The intensity and aggressiveness of competition isolates the more important – yet intangible – aspect of business: the value provided by expert opinion. Moreover, competitive pressures leading to a fixation on scale economies can then create pressure to have people conform to the common information systems they use, as the different expertise provided by individuals is seen as a cost rather than a benefit. A box-ticking mentality can emerge due to the fact that paper-work, words and numbers dominate rather than support the “gut feel” that is required for effective decision-making. Ironically, the poor performance that usually follows such developments is generally addressed by imposing more box-ticking requirements (eg “tougher” regulations).

Our growing technological sophistication has tended to encourage the view that formal processes and systems can be used in an increasing complex market economy to provide least-cost certainty. In reality, the exact opposite is true. As noted by Francis Fukuyama, the need for informality to support the “human dimension” in business is becoming more – not less – important:⁸

The fact of the matter is that coordination based on informal norms remains an important part of modern economies, and arguably becomes more important as the nature of economic activity becomes more complex and technologically sophisticated. Many complex services are very costly to monitor and are better controlled through internalised professional standards than through formal monitoring mechanisms. A highly educated software engineer often knows much more about his or her own productivity than his or her supervisor; procurement is often more efficient when left to the judgement of an experienced procurement officer, rather than being done “by the book” as in the case of a good deal of government procurement.

As discussed later in the submission, the removal of economic barriers worldwide is creating larger people-based systems and networks that demonstrate features similar to that of physical infrastructure. The key issue for micro-economic reform is that it makes it more difficult for government’s to second-guess the dynamic nature of the

⁶ QR has attached a report it had commissioned to review a book on the impact of reforms to the UK rail industry. A major theme of the report is that reform should be seen as encouraging “separate responsibilities, common purpose” and that the role of government is one of aligning our values to arrive at a common purpose.

⁷ Work being conducted by Network Access suggests that one possible reason for the development of state-based, publicly-owned monopolies in Australia was to actually avoid the problems that come with information and transparency “over-load” often experienced in modern-day business (and government). By minimising external scrutiny, monopolies were able to maximise the prospect of the non-scientific or “artistic” aspects of commercial decision-making, as a monopoly mean very little need for formal justification of what cannot be justified.

⁸ Fukuyama, F. (1999), “Social Capital and Civil Society”, A paper delivered at IMF Conference on Second Generation Reforms, Washington DC, 8-9 November (see www.worldbank.org).

interfaces between customers and commercial providers. As noted by the Business Council of Australia:⁹

With change occurring so quickly, there is a growing need to focus on the dynamic nature of competition. This in turn raised questions about how legal frameworks and regulators deal with changes, given legal and regulatory processes take time and involve significant cost.

The more vigorous the economy becomes because of less government involvement, the harder it becomes to understand the market and thus provide a quantifiable account of where it is headed and logical reasons for why such a policy was embraced in the first place. Ironically, this process is effectively confirming that true efficiency cannot be measured. The ultimate objective of NCP is not subject to a box, as it is not possible to pre-empt the human judgement that is required for truly efficient outcomes.

3.1.2 Communication

The indefinable objective of NCP has serious implications for policy development and, more importantly, how it is communicated to the community. The “leap of faith” aspects of NCP do not sit well with growing expectations that all aspects of policy should be assessed against measured outcomes. Greater across-the-board transparency requirements are promoting the view that accountability equates with “hard” proof of success or failure. Initial poor communication regarding the goals of NCP is now contributing to resistance to further change.

In the covering letter to Ministers from the architects of NCP, the “Hilmer Committee”, stated that:¹⁰

The Inquiry found strong and widespread community support for implementing an effective national competition policy.

This has not been the experience of QR. NCP has been more a matter of “this is going to happen, so here it is” – even if we do not quite know what “it” is.

People are unlikely to realise that market-based initiatives are attempting to recognise the innate value of individual effort if the reasons given for change are founded in a lack of trust. NCP has not been implemented because it makes sense – it was presented in a threatening fashion, with very little real engagement with those affected. Those championing NCP have generally not got past the concept to the real issues of implementation. Ironically, the details could not be specified as what was efficient could not be pre-empted. This dilemma, however, was not conveyed to stakeholders – most likely because it was not “seen” at the time.

There has been an inadequate and potentially contradictory response to those questioning NCP. If the unencumbered workings of the free market make sense, then surely it must be a simple proposition to gain common support for policies such as NCP? If the objective of NCP is welfare and significant sections of the community

⁹ BCA (2002), Inquiry into Trade Practice Act 1974 and its Administration (Dawson Review), 9 July, p. 20 (see www.bca.com.au).

¹⁰ Independent Committee of Inquiry into Competition Policy in Australia (1993), *National Competition Policy: Report by the Independent Committee of Inquiry into Competition Policy in Australia*, AGPS, Canberra. Note that this statement is altered somewhat in the report proper when it refers to support as reflected in submissions to the Inquiry. Like many other organisations affected by NCP, QR at the time of Hilmer had very little idea what the policy was going to translate into in a day-to-day sense.

are not feeling positive about it, does this reflect something amiss with the policy or is it assumed that people are incapable of judging what is right for them? Moreover, how can government and policy-makers discern the difference between legitimate stakeholder concerns and vested interests if there is a working assumption that anyone who raises an issue must necessarily be self-serving?

Rather than productive stakeholder engagement, market-based policies such as privatisation and structural reform have often been pursued for the wrong reasons, both in Australia and overseas. State governments have been coerced through NCP payments. Governments and policy-makers have asked Australians to have faith in NCP, but have then lacked conviction themselves, insofar as they have not explained (maybe because they didn't realise) that success against the objective of economic reform cannot be proved. The lack of effective communication on the essence of NCP is adding to the existing cynicism created by the reforms themselves.

3.1.3 Cost of Cynicism

A major threshold issue for QR is the barriers it faces when presenting its views on economic policy and NCP.

The first-hand experience of QR with the impact and process of micro-economic reform should be a positive when it comes to advice on future policy developments. This does not seem to be the case. Rather, QR continues to be seen by many stakeholders as less-than-relevant, simply because its vertically integrated structure and public ownership are considered to be consistent with the "bad old days" of lazy monopolies.

This cynicism goes to the heart of the limitations associated with NCP. The difficulty QR faces in having other parties objectively receive its views, is part of the box-ticking mentality that threatens good policy development and implementation. Comments made by QR are often taken with a "grain of salt" because it has already been placed in the wrong "box" – that is, it is not a "dynamic" private sector organisation who faces intense competition in product and capital markets on a day-to-day basis.

This presents a dilemma for QR. How does it overcome perception issues, especially when the regulatory arrangements essentially assume that it is intent on unreasonable dealings with its customers? Even referencing this inherent prejudice is likely to gain a cynical response.

How does one point out the cost of cynicism to those that are already cynical? This situation is made especially hard when hitherto distrustfulness is seen as a crucial part of the successful turn-around in economic performance. Without the scepticism of the late-1980s, it is unlikely that Australia would have progressed into such a strong economic position. While this may be true, it is also possible that a lack of trust is resulting in us overlooking legitimate concerns that stem from a lack of trust.

Dismissing resistance to NCP as being "irrational" is also questionable, as economic reform itself is supported by an objective which is very non-scientific. The NCP approach is about removing legislation and controls that established specific boxes (eg state rail monopoly) that limited productive economic activity. However, when the policy itself comes up against criticism, the common response is to place all those expressing a less-than-completely-supportive view in a box marked "vested interests".

QR does not believe that this dilemma can be “solved” by attempting to compel others to agree. The pressure that has accompanied NCP is also responsible for holding the current debate in an unproductive loop of searching for a literal answer to the question of efficiency. QR believes that things will only change for the better by easing pressure – not adding to it. As suggested by Onora O’Neill, trust cannot be engendered by expecting others to see the value in what it is you are attempting to say.¹¹

Elaborate measures to ensure that people keep agreements and do not betray trust must, in the end, be backed by – trust. At some point we just have to trust ... So trust cannot presuppose or require a watertight guarantee of others’ performance, and cannot rationally be withheld just because we lack guarantees.

What can be done, however, is an attempt to present a context for why NCP policy and the like have not led to an unambiguously positive outcome. QR does not present its views as criticism. And it is not suggesting that Australia return to the days of monopolistic infrastructure provision along industry and regional lines.

QR wishes to contribute to the debate, but the first step is to have its views considered on the basis of merit and not because of its structure or ownership status. It is important that those driving the policy process see the dilemma for certain organisations that are commenting on past or prospective reforms. It is only likely that this will occur, however, if those involved in policy development first accept the dilemmas that they face, particularly the fact that effective reform will lead to a situation where governments and their agencies will be less able to demonstrate the efficacy of what they claim they have achieved.

2.2 Regulation

Regulation has been productive for QR insofar as it has put a greater focus on network efficiency and clarified roles and responsibilities. As with other NCP-related measures, however, it can tend to become a burden when this process has been sufficiently progressed. Once regulation becomes a marginal exercise, the institutional momentum can create frustration and a propensity for unrealistic expectations concerning what regulators can and cannot actually achieve. For example, the recent Senate Report on the *Trade Practice Act 1974* made the following observation:¹²

The ACCC [Australian Competition and Consumer Commission] requires a tool which will enable it to act in ‘real business time’ yet which will protect the rights of companies.

While this statement is understandable, there simply is no such “tool” available. If the regulator is there in real time, then they should have no problem determining if an organisation was acting in a fair and reasonable manner because they would effectively be duplicating their job. To do this adequately, of course, the regulator would have to look over the shoulder of every employee involved in making a

¹¹ O’Neill, O. (2002), *A Question of Trust*, The BBC Reith Lectures, Cambridge University Press. Baroness O’Neill is Principal at Newnham College, Cambridge University and has written extensively on ethics and political philosophy.

¹² Commonwealth Senate Economics Reference Committee (2004), “The effectiveness of the *Trade Practice Act 1974* in protecting small business”, Report, Parliament of Australia, March, p. xix.

decision that affected the business (which is likely to be everyone at every point in time).

The regulatory process can also trend towards a “battle” between infrastructure manager, users and the regulator, on behalf of the community, over the inevitable differences that arise on various matters. This can take the focus off what is supposed to be achieved at a high level and place disproportionate attention on the minutia. As noted by Epic Energy in a recent Commission Inquiry, regulators often look at the parts rather than assessing access and pricing issues at the whole-of-system level:¹³

There is a single, overall process of [regulatory] assessment, which involves inter-related components or elements – it does not involve a series of individual, final decisions which severally and mechanically produce an outcome.

The sole issue for a regulator is to assess whether the access arrangements should be approved. The regulator’s task is not one of calculating its own reference tariff, or putting forward its own reference tariff policy or access terms and conditions. Furthermore, any attempt to segment the process of assessment and approval into sequential and component parts denies the fundamental nature of the process as a single one, and precludes attainment of the harmony and consistency which is achieved by a proper understanding and application of [the factors that shape efficient access terms and conditions].

QR took a similar view in its regulated Undertaking, when it suggested that access would be provided on a “reasonable” basis to its network customers. The specific details are important, but an efficient infrastructure manager must always base access terms and conditions on the performance of the entire network. Because the whole is greater than the sum of its parts, this approach requires an artistic discretion that cannot be defined. Such a position, however intuitive, is difficult to sustain. The dilemma faced by QR and Network Access is well represented in the following comments by the regulator on the draft Undertaking:¹⁴

QR’s position is ambiguous. Whilst it could be interpreted to be consistent with QR being assessed against efficient benchmarks for the purposes of revenue adequacy, the precise meaning of ‘reasonably expected improvements in efficiency’ is unclear. The Authority considers it desirable that there be as little ambiguity in the Undertaking as possible. Consequently, the Authority believes it is important that the emphasis be placed on efficiency of operations and the assets required to efficiently provide the relevant service.

In effect, the QCA is being ambiguous about the extent of ambiguity it is willing to allow. This highlights a central challenge for NCP. An expectation of fixed terms and conditions is making stakeholders less-and-less willing to accept that discretion is an essential part of a dynamic system such as infrastructure.

All this means regulators must also possess a degree of discretion in interpreting the discretion needed by the regulated entity. Regulators can never have the same level of information as an infrastructure manager. More tellingly, it cannot expect to have the non-transferable skills of those involved in commercial decision-making on a day-

¹³ Epic Energy submission to Review of Gas Access Regime, sub # 106, pp. 20-21.

¹⁴ Queensland Competition Authority (2000), Draft Decision on QR’s Draft Undertaking, December, p. 199 (see www.qca.org.au).

to-day basis. Regulation is also an art, as it must interpret and judge the discretion exercised by commercial providers. As expressed by Ray Gifford:¹⁵

The greatest challenge for the [Colorado Public Utilities] Commission, however, is finding an analytical foothold from which to evaluate the respective merits of parties' pricing proposals. Because the pricing methodology is forward-looking and based on hypothetical, efficient, future built networks, a whole range of plausible assumptions can produce disparate results. ... The [regulated] prices inevitably are the product of art, surmise and informed predication about forward-looking costs.

The rail industry, as with other sectors, faces pressure to have a national approach to rail (and transport) access and safety regulation. While QR supports such efforts, this approach is not going to be a panacea for what some stakeholders see as uncertainty arising from the various interfaces that must be managed when using infrastructure over long distances. A national regulator may be efficient provided it has the ability and willingness to provide for a discretionary approach. The risks of a push for uniformity – as opposed to a consistent approach – were documented by Epic Energy.¹⁶

Removing the discretion of the Regulator exposes stakeholders to the real risk that we will end up with a uniform set of terms and conditions, pricing formula and values for key elements in that pricing formula being adopted for all covered pipelines. This ignores the very reality that each pipeline's circumstances differ and as such flexibility to required to enable those differences to be addressed and factored into the regulatory approval process.

Regulation requires discretion in order to deal with the discretion needed by those being regulated. This conflicts with growing expectations of certainty. NCP has no way of resolving this situation as it has not adequately acknowledged the dilemmas with the core economic theory from which it has been drawn.

2.3 Competition

It is clear that the move from monopolies to a competitive market has had a number of beneficial outcomes for railways and the broader economy. That said, the economic reform process has led to a feeling that something has also been "lost". An intense competitive environment can erode a deeper sense of purpose and actually undermine longer-term performance. This has been experienced acutely in the United Kingdom (UK), as detailed by Christian Wolmar:¹⁷

Under British Rail, operating managers attempted to do everything they could to minimise delays and keep the railway running. They did not need the threat of fines or the possible loss of their franchise in order to do so. Their job was to operate the railway and they took pride in that task, often going well beyond their immediate responsibility. Furthermore, they saw themselves as a "community" and not as protagonists in a blame culture.

¹⁵ Gifford, R. (2003), *Regulatory Impressionism: What Regulators Can and Cannot Do*, Review of Network Economics 2(4), December, p. 474 (see www.rnejournal.com). Mr Gifford is a former Chairman of the Colorado Public Utilities Commission.

¹⁶ *ibid*, p. 22.

¹⁷ Wolmar, C. (2001), *Broken Rails – How Privatisation Wrecked Britain's Railways*, Aurum Press, Second Edition, p. 255.

An emerging area of research in economics and related fields concerns the issue of social capital. The Commission's work in this area noted the following World Bank definition:¹⁸

The social capital of a society included the institutions, the relationships, the attitudes and values that govern interactions among people and contribute to economic and social development. Social capital, however, is not simply the sum of institutions which underpin society, it is also the glue that holds them together. It includes the shared values and rules for social conduct expressed in personal relationships, trust, and a common sense of 'civic' responsibility, that makes society more than just a collection of individuals.

QR is of the view that NCP reforms have unwittingly undermined trust. This is hardly surprising when one considers the key features of the supporting policy framework:

- *Opportunity Cost* – The core principle of economics is that we have limited resources, which cannot be consumed more than once. Resources must be rationed through the price mechanism, with higher demand equating to a higher price. Competition is considered to be the best possible way of ensuring that this process maximises the benefit the community receives from its resources.

The scarcity concept, however, is in direct conflict with the notion of trust, which is taken to be "priceless" and something that actually increases with "consumption". As noted by Eva Cox:¹⁹

Trust should be defined as inexhaustible because it is increased, rather than depleted by positive use. The more we work together with others in environments which encourage cooperation the more likely we are to trust others, and the occasional failures of trust will be less damaging. Social capital is therefore increased by use. It can be depleted by widespread lack of trust or by our failure to trust others. Without trust we avoid contact with others because we fear betrayal. This is the core component of social connections.

Competition discourages people to work together, as they are potential rivals for the limited resources available for their personal survival.

- *Segmentation* – The directional force of competition is segmentation. The drive for efficiency breaks down industries (at the policy level) and organisations (at the commercial level). The ultimate goal of competition is to isolate and assess individual performance. While such processes are often designed to have such information used as a basis for improved teamwork, the contradiction can prove difficult to overcome.
- *Formality* – Competition is effective in generating information for use in information and data-based systems. For this reason, it tends to elevate the importance of formal over informal processes. With so much information built around specific measures of success (eg increase profit, reduce cost, cut staff numbers), businesses often come to rely on what is "real" over the intangible, when faced with increasing competitive pressure. This places undue emphasis on systems and contracts. These formal measures, however,

¹⁸ Productivity Commission (2003), *Social Capital: Reviewing the Concepts and its Policy Implications*, Research Paper, July.

¹⁹ Cox, E. (1995), "A Truly Civil Society: Raising Social Capital", Boyer Lectures, ABC Books.

cannot be expected to be a one-for-one substitute for the trust needed to allow expertise to be properly valued. It is not possible to adequately capture what it means to do the “right thing” in a contract involving words and numbers. As noted by Fukuyama, a goodwill dimension is needed for efficient outcomes:

No contract can possibly specify every contingency that may arise between the parties; most presuppose a certain amount of goodwill that prevents the parties from taking advantage of unforeseen loopholes. Contracts that do seek to try to specify all contingencies – like the job-control labour pacts renegotiated in the auto industry that were as thick as telephone books – end up being very inflexible and costly to enforce.

As evidenced in the UK rail industry reforms, detailed contracts can easily become a vehicle for adopting literal interpretations in order to avoid responsibility, with the end result being poor performance.²⁰

At first [after privatisation], we all worked together under the old rules, just as if we were all with the same company. We knew that there were these contracts but we ignored them. Then as more new people came into the industry and started applying the letter of the contracts, things deteriorated and services suffered as a result.

- *Risk* – Competition provides an incentive to better manage risk for financial reward. While this is true to a point, it can also lead to an unproductive process of seeking to lock-down cash-flow and transfer risk to whatever party can be threatened, coerced or told by the regulator to take it. Performance assessment in terms of risk is moving away from “how well was it managed” to a greater focus on “how well was it unloaded onto another party”. Such attitudes work against social norms of shared responsibility, as it implies that certainty can be obtained at the expense of someone else.

The efficacy of competition requires frank and constructive consideration. QR believes the competition core of NCP should be viewed as a necessary but insufficient step forward in terms of policy development. It is an improvement on the previous arrangements, but the current fixation on competition as a policy saviour is naïve. Competition directly conflicts with personal needs that are more important than economic wealth (eg trust). This suggests that it cannot, therefore, be the ultimate policy solution.

In a similar vein, QR does not see the issue in terms of “creating” more social capital to off-set the impacts of competition. The norms and values that allow people to have the confidence to exercise their judgement still exist. What is needed is an acknowledgement that competition can actually add to rigidity if the formal processes are seen as an end in themselves. Competition is about a means of providing for improved performance at the collective level, by having individuals assume the role that is best for them. There needs to be another step in the policy process that overcomes the apparent contradiction that focussing on the individual can be a means of improving society as a whole.²¹

²⁰ *ibid*, p. 195.

²¹ Note that this is consistent with Adam Smith’s observations that the individual, left free to act upon their own self-interests, will naturally provide for outcomes that improve the lot of society as a whole.

2.4 Private Sector

Greater private sector involvement in the economy has brought many positives. QR works closely with many private sector customers and partners, and continues to see these relationships as important to its commercial success. Greater private sector participation, however, is not a ready-made solution for further improving our economic circumstances.

Privatisation is often championed as a means of delivering better service. In QR's view, however, it has generally been adopted for other narrower reasons. As discussed in the Attachment, it appears that the privatisation efforts of the UK Government in the 1990s were more about achieving "certainty" for the Budget (which was not achieved) and being rid of former British Rail staff, than it was about efficiency.

In Australia, Victoria has endured a milder, albeit similar, experience. The sale of public assets was chiefly designed to boost state revenues and lock-down the size of the public transport subsidy. These are clearly important objectives, but not as important as having an efficiently functioning transport system.

The financial consequences of the recent departure of Melbourne transport operator, National Express, have been limited because the strong financial focus led to water-tight contract provisions. But this overlooks the fact that the public have still not received the quality service that was promised. Compensation through the forfeiture of financial securities by those who fail franchise conditions, is not the measure of ultimate success. It is widely recognised that the urban transport franchisees in Victoria were overly optimistic with patronage revenue forecasts. They were likely accepted because they were assessed against second-order objectives such as improved budget outcomes or a favourable disposition toward the private sector.

Privatisation is often founded in the belief that issues of concern to the community (eg service levels) can be adequately reflected in a formal contract. As outlined by Fukuyama and O'Neill, however, such contracts must acknowledge something that is beyond the contract itself – goodwill. Ironically, for this to be present, each party must be free of expectations that the contract represents an absolute guarantee. In effect, the contract will only serve its purpose if both parties agree that it cannot address all relevant issues.

QR believes public ownership has been retained in some jurisdictions because it gives governments a better chance of having the service provider understand what is really required under the contract. In a cynical environment, this "read between the lines" approach is taken as a means of providing a government entity with an unfair advantage. An alternative view would suggest that public ownership is an acknowledgement that a formal contract will be counter-productive if it is not supported by two-way discretion and that such flexibility is unlikely to be achieved with a private sector party.

The issue of whether or not a government can suitably contract with the private sector depends on the intent of those involved. A contract needs to be flexible to allow expert-provided information to flow between the parties. The most crucial part of a contract is therefore the willingness to work for common interests. As noted in the Attachment, this can be difficult to achieve when private sector firms are expected, if not encouraged, to pursue their self-interests over that of the broader community, as represented by the government. Attempting to use the contract as a

basis for aligning interests is likely to prove problematic, as it misses the point concerning the purpose of the document.

Private sector involvement initiated as part of NCP will only be effective if done for the right reasons. A belief that simply changing the ownership status will automatically improve our economic well-being is likely to have detrimental impacts over the longer term.

3 Key Policy Dilemmas

The issues raised by QR in the previous section arise because of the unique aspects of a network business, such as shared access and a high level of fixed cost.

Assessing the trade-offs and flow-on impacts of the decisions required for an efficient network are not amenable to a scientific formula. While objective information is necessary, good decisions require the value add of expert human judgement. The importance of a gut feel for what is right, was noted by Wolmar in respect of the former management style of British Rail:²²

Historically, the rails had been replaced [in this particular tunnel] every six years, about eight times more frequently than normal. No science had been called on, no textbooks consulted. It was just that the old BR engineers knew that the conditions required such frequent replacements or otherwise there would be broken rails. Railtrack changed that. The local zone director decided to save 50 per cent of the costs. Suddenly, in a seven-month period there were four broken rails, all involving sections that were more than six years old.

QR is not suggesting that policy (or commercial organisations) is best administered without any data or information – just that it must be integrated with actual know-how. Objective information is required for good decisions, but means nothing in and of itself. It must be interpreted by someone who has the expertise to know what it “means”. This distinction – and the risks of not properly understanding it – was well made by Ms O’Neill.²³

The illusionary quest for objective and quantitative methods of measuring all performance and for total transparency provides no more than spurious precision and an illusion of accountability.

Recording performance by requiring ticks in boxes may be neither cheap, nor objective, nor transparent. A car is well serviced only when the mechanic does an expert job, whether or not he ticks all the boxes. The tick in the box may be objective enough: but what counts is whether it accurately represents an expert underlying performance. Management by performance indicators, and checking success by ticking boxes to represent scores on these indicators, makes expertise redundant. The price for doing so is often loss of objectivity.

Micro-economic reform is at risk of undermining its objectives if it becomes overly formal and mechanistic in nature. The outcomes expected of NCP cannot be forced or mandated, as they are not able to be quantified in a formal way. QR believes the dilemmas it has experienced in respect of the reform of its network business, provides a sound starting point for examining how NCP and economic policy can be improved.

Physical networks provide an insight into the challenges ahead for policy-makers and regulators because a modern economy is taking on the form of a system of inter-related, physical and non-physical global networks. Businesses are increasingly knowledge driven, with internal management and external partnerships providing a process for integrating skills and expertise. These personal relationships are based on sharing, thus making it difficult to isolate individual performance and costs. As

²² *ibid*, p. 168.

²³ This is an extract from an unpublished working paper.

noted above by Fukuyama, technology is making the skills of the individual even more important and less amenable to “by the book” rules.

QR believes that the concerns associated with NCP all stem from the definitional dilemmas associated with efficiency. As identified by the Hilmer Committee, more efficient outcomes are not an end in themselves. All policy reforms and their implementation must relate back to a positive for the community, insofar as it recognises the value of our physical and non-physical resources. Understanding the detailed steps that must be taken to actually make this happen in a practical sense can prove to be difficult. As noted by the Commission:²⁴

The ultimate objective of access legislation is to enhance community welfare. In an operational sense, however, this is difficult to convey in a meaningful way. To this end, the objective of Part IIIA [of the *Trade Practices Act 1974*] has been couched in terms of promoting competition in the delivery of infrastructure services.

If the policy framework is to be effective, it needs to acknowledge the vagueness of what is actually being contemplated with NCP. There is no prescribed solution. Terms such as “efficient” and “world best practice” can be counter-productive if not accompanied by a suitable qualifying context. By admission of the underlying economic theory, we cannot predict what an efficient outcome will constitute. Likewise, assessing if a particular policy or regulatory decision is efficient cannot be proved, as it requires consideration of real time issues.²⁵ As implied by QR to the Australian Logistics Council, applying regulation before the event restricts efficiency, while exercising it afterwards will not prevent inappropriate behaviour:²⁶

It is therefore not possible to present empirical evidence to conclusively prove that something is efficient. Data can be presented *ex post* and forecasts can be made on what constitutes efficient access – but the most important aspect of efficiency is occurring now. This is the reason why QR has consistently expressed real time issues as a major factor in assessing its efficiency. A train controller, for example, must make decisions that account for the coalescence of several inter-related issues concerning rail-track access. While guidelines can be prepared and agreed on a list of efficiency drivers, contingencies will be required and judgements will be made as the interactions of users have both real time and long-term impacts on the efficient use of infrastructure.

NCP was introduced because the dynamic nature of market efficiency was outside the ability of government to manage. The implications of this in terms of regulation, however, have not been adequately acknowledged. There are often stated principles such as “lighted-handed regulation is favoured”, but in practice governments, regulators and most stakeholders (provided it does not directly affect them) constantly push for more regulation.

We have thus been left with a policy foundation which makes “sense” – better use of our resources must be a good thing – but has caused unintended conflict because those that implemented it failed to advise of its vague nature.

A key consequence of this dilemma is that regulation can be expected to become more heavy-handed. Once in place, regulators tend to want to “do things” and “fix problems”, as their existence is premised on there being something wrong (eg

²⁴ Productivity Commission (2001), *Review of the National Access Regime*, Report #17, AusInfo, Canberra.

²⁵ This was the nub of the issue that prompted the Senate Committee comment cited in section 2.2.

²⁶ QR submission to Australian Logistics Council, “Towards an Effective Access Regime”, August 2003 (see www.qr.com.au).

monopoly pricing). In many cases, therefore, regulatory intentions have gone astray. As noted by Network Economics Consulting Group:²⁷

Yet, in the face of [the limitations of the current regulatory model], it seems that regulatory authorities are increasingly exerting downward pressure on key regulatory parameters. There is a danger that the current “cost of service” approach to regulation will entrench the heavy handed regulatory system rather than evolving to a light handed approach. There is also a risk that the emerging “heavy handed” approach to quality regulation will consign a substantial proportion of the customer base to low cost, low value price service quality packages, resulting in a substantial loss of allocative efficiency.

Government and regulators don’t set-out to become proxies for commercial management, but invariably do. This seems to happen because regulation “chases its own tail”. Once a question such as “does this organisation have market power?” or “what is an efficient access price?” is posed, there is no way of adequately addressing it. Frustration then inevitably arises, as the institutions have been established on the basis that there is a literal answer to be provided.

At the core of this circularity is the issue of discretion and how “much” is required for regulated entities. As discussed above, a regulator will ask for clarification of what is deemed to be reasonable. This question brings the essence of the dilemma to the surface: how far does the regulator go in terms of displacing the discretion of a commercial provider? “Some” flexibility would seem to be just as unsatisfactory as a “lot”, given neither provide the regulator with certainty.

On this basis, light-handed regulation does not make sense. Regulators really only have one of two choices:

1. If one accepts discretion is desirable and necessary for efficient operation, then it follows that a regulator must trust those it is regulating, as it is not possible to prove why certain decisions were taken; or
2. If certainty is taken to mean understanding everything, then the notion of light-handed regulation should be abandoned and the discretion currently needed by commercial providers transferred to regulators.

The logical conclusion of (1) is that a regulator will eventually become pointless, provided trust can be found at all levels of the policy hierarchy: infrastructure providers, customers, regulators, governments and the public. The extension of (2) is that the government should assume the role of commercial decision-making.

It is often suggested that regulation needs to be “balanced”. QR suspects that this thinking is often confused with a compromise that sees us operate somewhere between these two points. The desire for equilibrium is really concerned with absolutes, such as real time, trust and unity. In effect, the regulatory framework is driving us towards either complete trust or complete distrust. The notion of “some” trust does not coincide with our intuitive sense that efficiency is an all-or-nothing proposition.

These dynamics can prove to be confounding when incorporated into a policy framework. As raised by QR earlier, the cynicism that has accompanied NCP can

²⁷ NCG (2002), *Options for Changing Australia’s Regulation of Electricity Distributors*, Report to the Electricity Supply Association of Australia, December, p. 10 (see www.necg.com.au).

easily lock one out of seeing the nature of this dilemma. The question of why we cannot achieve light-handed regulation has no answer because it stems from a higher-order question without an answer: what is efficiency? What is more, those questioning the trend towards more imposing regulation are likely to eventually face a cynical response themselves, as more questions-without-answers will only heighten the frustration. As identified by Hugh Morgan, Chairman of the Business Council of Australia:²⁸

When we have an ever growing accumulation of regulations and regulators, we are like a person who feels “sort of all right”, but not really brimming with energy, but who in fact has an unrecognised and certainly undiagnosed, malignant cancer. We are in the position of a person who is not feeling 100 percent, but is very reluctant to go to a doctor, because there is a fear of the diagnosis and the consequences of the surgery that might follow.

This is not an attack on regulators. It is an attempt to grapple with the realisation that we have got a problem; but it is a problem for which the answer is not readily apparent. [Moreover], the arguments that we employ to shake the resolve of governments to rethink their re-regulatory ambitions are difficult to achieve traction. When we suggest, in the most deferential language, that we do not like what is being done, and that we will campaign against it, the amused response is: “Make my day!”

Regardless of how congenial the language, if the intent of the question involves the need of a formal answer then it must become part of the problem. An expectation that a clear cause-and-effect relationship should be evident means that one has missed the point and may well be taking the issue further from resolution.

It is important that such dilemmas be reflected in the economic reform process. In particular, NCP should include a reminder that:

- there are no obvious solutions to what needs to be done in terms of economic reform because the nature of the problem cannot be adequately defined by virtue of the fact that the objective of NCP cannot be defined;
- the more that is achieved in terms of greater efficiency, the more difficult this definitional dilemma becomes;
- this dilemma is likely to result in frustration building up within existing institutions that could then lead to the mistaken belief that regulation can effectively second-guess efficient commercial practice; and
- the certainty that is desired by the community is an absolute that will only be achieved with absolute trust – using regulation to “balance” trust and distrust will only institutionalise growing uncertainty.

The difficulty in assessing the effectiveness of a policy such as NCP cascades into all related initiatives (eg third party access) and, to a large extent, commercial practice. The inability to provide a rational definition of what NCP is, is at the heart of the issues discussed below.

²⁸ Morgan, H. (2004), “Civil Society, the Corporation and Regulation”, BCA Address to Committee for Economic Development of Australia, Melbourne, 22 March.

3.1 Interfaces

A centralised policy approach such as NCP makes sense in terms of achieving a consistent basis for a level playing field. But as with a corporate function within a company, such a policy process must always recall that its core purpose is one of facilitation. As discussed throughout the submission, it is not possible to pre-empt the right decisions. NCP will only be effective over the longer-term if it can successfully tap into the expert advice that lies with sub-national governments and commercial providers.

Infrastructure provides a relevant context for considering the interface issues that need to be addressed if NCP is not going to become bogged down in conflict and bureaucracy.

Prior to the reform agenda, infrastructure was managed as a series of separate regional monopolies. This disaggregated approach allowed for local knowledge to be applied to localised transport, energy and water needs. Industry reform, open access, privatisations, budget pressures and various other initiatives, have pushed for a more holistic approach to infrastructure provision, planning and regulation. The efficiency objective of competitive neutrality requires a national policy framework that essentially integrates several complex regional and inter-industry networks (eg rail-road, electricity-gas). While this facilitates a big picture approach to policy development, it does not cancel out the fact that the needs of the community are represented by the sum of localised demand.

The allocative efficiency benefits of a national policy initiative such as NCP can be competed away by the growth of an unproductive bureaucracy between a centralised policy influence and the grass-roots provision of infrastructure and services.²⁹ While legislated monopolies had various potential inefficiencies, they did have the advantage of providing a relatively unrestricted flow of information between those with the knowledge and those required to confirm centralised funding, planning and investment decisions. Government-owned, regionally-focussed monopolies were able to exist with relatively informal relationships. This contrasts significantly with modern-day requirements for segmented roles and responsibilities that must meet extensive transparency requirements, with interfaces operated according to formal policy and contract-based obligations.

This has shifted the focus away from regional, industry sector know-how (eg rail services in south-east Queensland) to skills that can understand and account for national, multi-modal outcomes. In the process, the complexity has increased and those required to make the decisions have become less technical. This need not be a problem, provided there is an efficient flow of valuable information between those parties that require it through the policy hierarchy. This can be difficult to achieve, however, given the presence of greater competitive pressures (and commerciality issues) and fear that a centralised approach will compromise the needs of those claimed to be the beneficiaries of the change.

Ironically, the increased complexity from integrating systems has, on the one hand, increased the importance of human know-how, while on the other hand placing greater distance between this expertise and those that finalise the decisions. It is

²⁹ The transport planning regime in the European Union has been referred to as “apoplexy at the centre, paralysis at the extremities”.

important that policy-makers and other stakeholders acknowledge that a national approach to policy and regulation does not guarantee better outcomes, as the flow of expert knowledge up through the interfaces is what ultimately matters.

3.2 Role of Government

Closely related with the issues discussed above, is the changing role of governments and their agencies. This development was noted by the NTC:³⁰

There has been a shift in government from operating in a “doing” role to a “managing” role, along with increased commercialisation of many government services and privatisation of some services. There is likely to be increased emphasis on provision of roads as a business with long term planning cycles, and systems to provide demand and supply signals between infrastructure users and providers.

The transition to a “managing” approach is epitomised by the outcomes focussed approach to policy. The key outcome for NCP is allowing the “doing” to be done by those that have the know-how due to their day-to-day involvement.

The dilemma with this approach, however, is finding the right balance to ensure that the managing role does not become a pseudo form of doing. For instance, how far does a government go in devolving the doing role? Does success in NCP mean that governments end up doing “nothing”? Is NCP about an all-or-nothing role in the economy (similar to the situation discussed above with regulation) for government?

Managing and accounting for outcomes from more-and-more complex systems within systems, can lead governments to the same difficulties encountered when it was directly responsible for the vast majority of infrastructure and service provision. Managing may not really differ from doing where the relationship is dependent on adherence to an agreement or binding contract. A role designed for guiding or facilitating the “right” outcomes can easily become one of doing without realising it.

For instance, the managing for outcomes approach still requires governments, agencies (eg National Competition Council) and regulators to take a view on performance in terms of meeting certain outcomes. Modern notions of accountability demand that governments prove that goals have been fulfilled. But how does one assess performance when efficiency is beyond measurement and the ultimate goal is for governments to leave everything to commercial providers? Even on a practical level, it is near-impossible to determine performance within a dynamic and inter-related economy. Does the fact that a particular industry sector, organisation or individual improved from X to Y measure of productivity mean that it is now efficient?

An adaptive, complex system is defined by the nebulous relationship between cause and effect. If the individual parts each work well, then individual performance is effectively subsumed into the whole. As economic reform progresses, the whole is being defined more-and-more on a global scale.

The economic integration that is a consequence of reform is leading to a consolidated system, with outcomes and performance only really subject to collective assessment. This oneness principle was well articulated by Richard Bowker, Chairman of the UK Strategic Rail Authority, in respect of the rail industry:³¹

³⁰ *ibid*, p. 32.

³¹ Bowker, R. (2004), Speech to the National Rail Conference 2004, 11 February (see www.sra.gov.uk).

The railway is greater than the sum of its parts. From time to time we lose sight of that. And when we do, we're a lesser industry.

Collective responsibility is what underpins the railway. When it comes to delivering the service, how can you separate the responsibilities of a signaller from those of a driver? Or those of an operator from those of a rolling stock leasing company? There are no isolated decisions in the railway; no circuit breaker between the work of a planner and its impact on a contractor.

There is a oneness to the railway that is unique. That oneness is the holy grail of successful delivery, irrespective of how many bits are involved and no amount of structural change will compensate for a lack of that oneness – it's got to come from within us.

The role of government has moved from doing (eg command relationships within a publicly owned, vertically integrated monopoly) to managing (eg service contracts transparently funded and specified, nominated NCP outcomes). It is likely that there is another step for governments and that this is outside the existing paradigm.³² Marrying a more complex economic system with specific NCP performance requirements, is likely to present government with significant challenges when it comes to demonstrating to the community it has achieved its targets.

These challenges suggest that the next step cannot be “managed”. Apart from not being able to theoretically define or practically measure efficiency, any pressure from governments (or other stakeholders) will contradict the ultimate goal of alignment of a common purpose.

3.3 Performance Assessment

Performance assessment of a network business can be problematic, due to the inter-relatedness of the parts. As stated by Mr Bowker: “we either succeed together or fail together. There is no scenario for the future where some succeed and some fail. We have a common purpose that binds us together”.

As discussed elsewhere, this principle is becoming increasingly relevant for the economy in general. While individual roles and responsibilities can be identified in a conceptual sense, efficient performance is only really manifest at the whole-of-system level. This should be reflected in policy initiatives such as NCP.

From a community-wide perspective – which is the relevant level for government – it is therefore impossible to say that any one part of the “economic family” is more important than another. In the rail industry, for example, one can have the world's best train operators, but if those responsible for track maintenance do not do their job effectively, service to end users will be lacking. Moreover, a reversal of the situation (with a world-class infrastructure maintainer) could still realise the same outcome. Excellent maintenance and poor train management, and poor maintenance and excellent train management could have the same impact on the functioning of the network. Identical on-time running, number of accidents and/or financial return could therefore be realised for various combinations of the relative performance of different parts of the industry.

³² In the UK, it has been suggested that this role may be one of a “benign dictator”. This term was used by Steven Marshall, the then CEO of Railtrack, when suggesting the nature of the role for the Strategic Rail Authority (see Wolmar, p. 237).

Such performance assessment issues may not fit well with policy expectations, especially in situations where there is seen to be under-performance. There is no box to tick when things don't go to plan, largely because the problem will have been the result of the system, rather than just one isolated incident or individual.

The dilemma inherent in attempting to find a particular reason for why network performance is lacking, was amply demonstrated during the Special Commission of Inquiry into the Glenbrook Rail Accident that occurred in New South Wales (NSW) in 2000. At the initial stage of the Inquiry, the key government rail organisations involved submitted the follow reasons for the accident.³³

The fundamental cause, the real cause of the accident, involved two elements: firstly, a train was wrongly permitted to pass an automatic signal at stop. The second circumstance was that that train, given that permission, was driven too fast in the circumstances. They, in our respectful submission, are the causes of the accident.

This was a literal response to a process perceived to be about delivering a literal answer and clear-cut solution for the community. In spite of this, the Glenbrook Inquiry acknowledged that the rail industry is essentially an extended family that included the NSW Government itself. The report (p. 35) noted that there are a multitude of people and institutions (many of which are not readily apparent) that may contribute to performance, and thus a rail accident.

It is not only operational personnel who contribute to accidents ... The staff that determine the dwell time allowed at railway stations, the accountants and business managers who decide the resources that should be allocated to safety issues, and the chief executive officers who are under pressure to ensure on time running or to produce a financial return to the government, all significantly influence the latent circumstances which might give rise to a serious accident although the influence they might have may not be obvious.

In a similar vein, it saw performance as a matter of culture that was likely undermined by adopting a tick-a-box approach to solving problems (p. 40):

The tool of risk management is not a mechanical process. It requires thought and adaptability to the particular circumstances that exist at a particular time. A belief that all hazards can be identified and controlled is capable of producing the opposite of a culture of safety.

The implementation of a policy agenda such as NCP brings expectations of improved performance. If this is not delivered upon, governments and policy-makers will face pressure to "fix the problem".

This can present a severe challenge for governments, especially if the reforms and other previous initiatives have been presented as a cure-all. A sense of a ready-made solution will promote a view that any subsequent concerns can be overcome by simple means, such as re-structuring the industry, conducting independent inquiries or sacking senior executives. In a conflict-laden situation, there is a tendency to forget that policy performance must, increasingly, be assessed as a whole, rather than focussing on particular parts or individuals.

³³ McInerney, Hon P. A. (2001), "Special Commission of Inquiry Into the Glenbrook Rail Accident, Final Report", NSW Government, April, p. 14.

Moreover, there is a risk that government, regulators, policy-makers and the public preclude themselves from being part of the wider group that impacts performance. There are several examples in the rail industry, both here and overseas, where the situation has been made worse when governments attempt to deny the integrated nature of infrastructure performance. These issues will become more relevant for the economy in general, as barriers decrease and integration intensifies. A growing desire for oneness will require a committed co-operative approach to policy development and integration.

3.4 Market Power

The definitional limitations associated with efficiency are encapsulated well in the issue of market power. For example, the Hilmer Committee said (p. 69):

The central conundrum in addressing the problem of misuse of market power is that the problem is not well defined nor apparently amenable to clear definition. Even if particular types of conduct can be named it does not seem possible to define them, or in circumstances in which they should be treated as objectionable, with any great precision. For example, it may be possible to say “predatory pricing” is undesirable, but it does not seem possible to give a clear definition of what will amount to predatory pricing in all circumstances.

This is a conundrum. However, governments and regulators do not go on to ask if it arises because it has been assumed that those being regulated do not share the same purpose. A starting assumption that market power will be exercised must promote mistrust, which is then heightened by the presence of a regulatory regime.³⁴ This leads to discretion being reduced and so too the ability of commercial providers to make efficient decisions. The real conundrum is that the regulator (and various others) assume it can “beat” the initial conundrum simply by gaining more power, procuring more information and threatening those being regulated.

The scale economies associated with infrastructure can create difficulties for owners to recover sufficient costs. If prices are set at “efficient” levels (ie the marginal cost of allowing access to the track), a rail infrastructure owner is likely to face considerable losses. As noted by the Bureau of Transport and Regional Economics:³⁵

At the allocatively efficient output level, the rail infrastructure losses may be considerable. As the short-run marginal cost in rail infrastructure is considerably less than the average cost, the firm’s loss will be large relative to the revenue generated through access charges. At the prevailing demand in the rail industry, therefore, short-run marginal cost-based pricing can often make it impossible to provide financially free-standing rail infrastructure.

The consequence of this is that the infrastructure manager must apply a margin above short-run marginal cost. This task requires discretion, as there is no formula for making the right allocation. Indeed, this is formally acknowledged in the policy framework with economic guiding principles such as two-part tariffs, Ramsey pricing and marginal social cost. Different approaches and various assumptions on key

³⁴ A regulator may claim that the entity being regulated is assumed to be innocent (of market power, for example). However, if the regulated entity were innocent, why is it necessary for regulation to exist? If it is to guide, why does it contain sanctions and provisions to over-ride the commercial provider? In practice, regardless of good intentions, the presence of regulation contradicts the innocent-until-proven-guilty principle. In practice, it must tend towards the kind of situations identified by Mr Corbett (see page 26).

³⁵ BTRE (2003), *Rail Infrastructure Pricing: Principles and Practice*, Report # 109, p. 32

factors (eg demand elasticity, fixed cost shares) can result in different incentives and expectations on users, infrastructure managers and governments. Again, flexibility remains imperative:³⁶

Although economics may suggest principles for setting access charges, in practice there can be a range of ways of applying those charges. ... there is a considerable degree of ambiguity over cost causation, which can undermine the determination of appropriate pricing signals.

The ambiguity associated with infrastructure pricing is only a problem insofar as the infrastructure manager has been deemed to be not part of the “team” (ie untrustworthy). As discussed above, the cynicism associated with this separation provides an “impenetrable” barrier for regulated entities to be seen as anything other than having uncommon interests.

The economics framework fails to acknowledge that this cynicism puts it at “war” with itself.

The issue of price discrimination is one such example. The policy paradigm accepts that efficient pricing requires a flexible approach in order to cover costs. But the process also encourages regulators to second-guess the “appropriate” price, by either setting an alternative or by rejecting those recommended by the infrastructure manager. The frustration that this creates is then dealt with by attempting to reduce the flexibility that has already been sanctioned under the same policy framework. As noted by the Hilmer Committee (p. 167), there is no sound argument for regulators attempting to estimate an efficient price:

Quite apart from the technical difficulties associated with price setting, there is no clear *policy* basis for the setting of prices where there is no reference price. In such circumstances improving the technical expertise of courts, or referring pricing matters to specialist bodies, would not improve upon the existing [TPA] regime, and for this reason the Committee does not propose to make any special provision for pricing remedies.

Issues associated with market power have been the subject of much recent debate, including the effectiveness of bodies like the ACCC and the Australian Competition Tribunal. Such arguments, however, don’t resolve anything fundamental, as they simply focus on a particular group or individual as the problem (eg infrastructure manager, regulator, “big” business), when the concerns relate to the institutional arrangements and the theory that supports them.

The problem being confronted by regulators cannot be solved at the level at which it is manifest.

The key issue for QR is that a lack of recognition of this situation can quickly lead to structural problems with the performance of infrastructure (and the economy in general). A mentality on the part of users that efficiency equates to water-tight, long-term minimum cost access fees, can create dangerous benchmarks. Rather than expend time and effort on difficult issues such as efficient price discrimination, some infrastructure managers and regulators have abandoned the flexibility of the negotiate-arbitrate model. Many overseas providers and the Australian Rail Track Corporation (ARTC) offer pre-determined, “posted” prices for certain railtrack services. It has been suggested that this approach will promote above-rail activity

³⁶ *ibid.*, p. 52.

because it meets the transparency and accountability expectations of users – that is, it ticks the right boxes. The ARTC made the following comment to the Commission:³⁷

ARTC seeks to stimulate customer confidence and market growth in the evolving market in which government owned vertically integrated railways are being replaced by privately owned operators with access to shared infrastructure. ... ARTC has adopted the concepts of equity and transparency as key elements of its pricing policy. ARTC will not price discriminate on the basis of the identity of the customer, the commodity being transported or the market being served.

ARTC appears to be of the view that trading-off a level of pricing flexibility to give customers what they believe to be certainty, will be in its long-term interests. QR believes this to be questionable and likely shaped by limited experience of what is actually entailed in managing an efficient railway over an extended period of time.³⁸ This approach sends the wrong signals to users, insofar as it encourages them to pursue short-term, fixed cost outcomes rather than supporting the development of a complex system of rail infrastructure.

In its submission to the Commission on this inquiry, the ARTC notes that it believes that controlling all inter-state railtrack would improve rail efficiency by providing continuity of access management. Apart from the fact that integration of policy, regulation and commercial access can be achieved without physical consolidation, QR believes that the current “lowest common denominator” approach taken by ARTC is likely to eventually provide for an unsustainable network.

Any resulting “crisis” (which will not be apparent for many years yet) will no doubt be blamed on the track manager. QR does not take any solace from this, as it believes remedying the decision to give up flexibility to achieve short-term outcomes that are in the real interests of no-one is a collective responsibility of all who shape and implement policy.

³⁷ Submission to National Access Regime Inquiry (#28, p.15)

³⁸ ARTC has only been in existence since 1997. Its main asset is the interstate line from Wolseley to Kalgoorlie, although it will shortly be taking over the inter-state network in NSW.

4 Conclusion

QR does not have a “solution” for the Commission when it comes to NCP. Changing structures and ownership, creating more powerful regulators or providing considerable financial incentives to change will not guarantee success, because the key ingredient needed to realise our economic goals – human judgement – cannot be pre-empted. Indeed, NCP is now at the point where more ready-made answers are likely to be counter-productive.

What it is hoped this submission provides is a context for why parts of NCP are not working. This is all that can be provided in a literal sense, given the essence of the policy goal defies definition. Without a positive statement of what efficiency is, it is really only possible to say what is inefficient and what is not good policy. The difficulties we face at present relate to contradictory attempts to specify what is needed in a positive manner (eg a regulator setting prices).

A negative definition for our policy approach worked well when NCP started out in the 1990s. Australia should not have legislated monopolies. We should not have restrictive regulation. These changes made sense, especially when the potential for gain was significant. There was very little consideration, however, of what would happen when the relatively easy gains had been made. Inefficiencies become extremely difficult to eliminate once general consensus breaks down and it is not possible to prescribe what must happen next. Even the Hilmer Committee assumed away this practical issue, presumably hoping that it would be resolved as part of the implementation:³⁹

... the challenge is to provide a system which can distinguish between desirable and undesirable activity while providing an acceptable level of business certainty. In this respect it is important to stress that uncertainty over the bounds of legally acceptable behaviour may deter efficient and socially useful competitive behaviour.

In addressing this challenge, the Committee starts from the position that there is already in place a regime which provides a basis for making the appropriate distinctions.

In a way, the implementation of NCP has revealed the “answer”: it is a contradiction to attempt to mandate efficiency, as there is no way of specifying in detail what needs to change in terms of “desirable and undesirable activity”. Policy-makers have the choice of either accepting this view (which is consistent with the supporting theory) or we can continue to chase our own policy tails.

As discussed in the previous sections, the various dilemmas innate to the economic framework have now emerged. The response to these dilemmas has been to battle away at a problem that has not been adequately defined. The effect of this has been to shift in effort away from removing barriers and restrictions to actively creating regulations and controls. While these interventions are adopted in the name of efficiency, they violate the core beliefs behind why NCP was implemented in the first place. QR believes it is important that such matters be recognised as part of the general micro-economic reform agenda. Without a clear appreciation of this situation stakeholders can become confused over the objectives, leading to the reform agenda becoming misdirected.

³⁹ *ibid.*, p. 69.

Frank statements concerning the efficacy of regulation, for example, are more likely to reduce conflict than is a denial of that fact that the ultimate objective we are working towards is vague and shifting, and that efforts along the way are subject to error and review.⁴⁰ The following statement by the New Zealand Government is instructive:⁴¹

The advantage of statutory underpinning is that parties will know the regulatory purpose and scope of the New Zealand Transport Strategy in advance and how the strategy may affect them. The main disadvantage is that a statutory process can be too rigid and inflexible, and open to interpretation. In these days of rapid technological and social change it is difficult, if not impossible, to develop a long-term strategy that will remain of value for any great length of time.

Prior to the reforms, the doing approach of government was very much centred on inputs. As the economy became more dynamic and markets were opened up to competition, governments moved to purchase and regulate for particular outcomes. This left how they were actually delivered to those best placed to make decisions on inputs – commercial providers. This reveals a key principle: less control by government means a better prospect of achieving the desired outcome of greater prosperity for the community.

Having gone from doing to managing, the logical next step with the less-is-more principle is for governments and their agencies to become something such as a “benign dictator”.

The most immediate issue that needs to be addressed is the growth in cynicism that accompanied NCP and a less efficient economy. Regulation in particular is creating a vicious cycle of blame and counter-blame that is likely to present a barrier to us seeing what needs to change. Regulators face the unenviable task of simultaneously attempting to co-operate with an entity it must also assume is guilty. The kind of unproductive outcome this dilemma can produce was alluded to recently by Roger Corbett, CEO of Woolworths:⁴²

The previous chairman [of the ACCC] said: “We should have a far more cooperative attitude. You should tell us what your problems are, and we should work with you on trying to get compliance”. But when we did that we found many of the officers really wanted to know the facts only to see if you had committed a breach.

This is clearly a leadership issue. It requires us to be frank about the cost of conflict and cynicism, without being “protective” of the merits of the economic policies that have delivered Australia significant prosperity. QR believes that many unnecessarily conclude that any concerns raised over NCP, competition or regulation is taken as meaning support for the opposite (eg legislated monopolies). QR is not about ticking an “anti-NCP” box – it wants to see the debate elevated beyond the idea that policy can mandate what needs to change.

⁴⁰ It is noted that the Commission has recently acknowledged the need to accept “regulatory error”. This is not the same, however, as accepting the more fundamental proposition that the error arises because regulation contradicts the economic theory upon which it is based.

⁴¹ New Zealand Ministry of Transport (2000), “Land Transport Policy Development: Stage One”, Consultation Paper, July (see www.transport.govt.nz).

⁴² Official Committee Senate Hansard, Economics Reference Committee, “The effectiveness of the *Trade Practice Act 1974* in protecting small business”, Hearings, Melbourne, 30 October 2003, E9

Governments and the community need to be advised that we are in a process that will tend to take us past measured forms of success. This scenario is a legacy of the fact that the micro-economic reform agenda has been implemented as an article of faith. There is no way to prove that efficiency is a worthwhile goal because it cannot be “captured”. Likewise, it cannot be forced as its inestimable nature means targets are of limited worth.

This dilemma was not apparent while there were easy gains to be had. This has now changed. But the breaking down of barriers and the greater transparency delivered by improved technology has also created an expectation that we should be able to achieve certainty and post an objective measure of success. An inability to dispel such views is placing at risk the gains made by NCP, particularly as the resulting anxiety is dealt with by implementing more regulation. This only fuels further expectations that cannot be met.

The fact that competition policy, regulation and the like cannot *per se* provide for certainty, needs to be presented in a different light. The resistance to NCP is not necessarily about vested interests. It is an attempt to have governments and policy-makers acknowledge what they claim they already know: that economic policy is only ever a means of removing restrictions to the flow of the ultimate resource needed for efficiency – people.

At the heart of economic reform is the desire for people to have the opportunity to be valued for what they can best personally provide for the community. Efficient resource allocation requires efficient use of people. Because there is no way of mandating what this is, there is no way of assessing if the policy objective has been achieved. Likewise, there is no way of determining if resistance to NCP is about vested interests or simply a gut feel that those implementing it see legislation and regulation as the solution rather than the people it is designed to support.

The only sustainable way forward for NCP is to assume that a common purpose already exists and that the role of government is to assist in uncovering what this actually is.

On this basis, QR recommends that the Commission consider the need for NCP to acknowledge that:

1. the economic theory that supports NCP means that it strives to achieve an outcome that cannot be defined or measured, and thus not subject to objective performance assessment;
2. the essence of NCP is to remove barriers and controls that allow resources to be allocated efficiently, based on the expert judgements made by people;
3. the flow of resources is contingent on a flow of information from people at the “grass-roots” level to those responsible for verifying decisions;
4. as the economy becomes more complex and integrated, the distance between technical expertise and the centralised decision-making process that looks to achieve economies of scale and consistent policy/regulation will become greater, while at the same time making such expertise more important;

5. many of the economic concepts associated with NCP conflict with the “social capital” needed to provide for the informal arrangements that facilitate trust and thus the flow of advice through hierarchical structures; and
6. the next step in the economic reform process needs to go beyond box-ticking notions, such as structure, ownership and measured performance, to the oneness that comes with integrating the tangible with the what is intangible but nonetheless real and of true value.