PRODUCTIVITY COMMISSION INQUIRY
REVIEW OF NATIONAL COMPETITION POLICY ARRANGEMENTS
ARTC SUBMISSION

Background

The Issues Paper prepared by the Productivity Commission in relation to its review of National Competition Policy (NCP) arrangements was issued in April 2004. The terms of reference for the inquiry require the Commission to undertake two distinct tasks:

- Assess the initial and ongoing impacts of NCP and related reforms undertaken to date; and

- Report on areas offering further opportunities for significant gains to the economy from removing impediments to efficiency and enhancing competition.

The Commission has sought comment, as well as factual input and specific examples of impacts that can be attributed to NCP reforms.

ARTC was created after the Commonwealth and State Governments agreed, in an Inter-Governmental Agreement (IGA), in 1997 to the formation of a 'one stop' shop for all train operators seeking access to the national interstate rail network. The IGA had a term of 5 years. ARTC is a company, under Corporation Law, in which shares are owned by the Australian Government through the Ministers for the Departments of Transport and Regional Services and Finance and Administration.

ARTC's formation was preceded by prior rail reforms that sought to separate rail infrastructure from the competitive functions of the rail transport industry in response to NCP. At the time, the Australian, NSW and Victorian Governments (interstate network) separated infrastructure from operations, whilst the Western Australian and Queensland Governments retain the previous vertically integrated nature of their railways, with a view to introduction regimes to provide for third party access.

Under the IGA, ARTC would be responsible for negotiating access to the national interstate rail network between Brisbane and Perth by virtue of direct ownership or lease of certain parts of the network, or under wholesale arrangements to be negotiated with State Government owners of other parts of the network as applicable.

ARTC commenced operations in 1998 with the following charter:

- Improve performance and efficiency of interstate rail infrastructure
- Increase capacity utilization
- Listen, understand and respond to the market
- Operate on sound commercial principles
- Provide shareholders with a sustainable return on capital invested

ARTC currently has responsibility for the management of 4430 route kilometres of standard gauge track, mainly in South Australia, Victoria and Western Australia. ARTC owns the following rail corridors:

- Adelaide – Wolseley
- Adelaide – Pt Augusta – Kalgoorlie
- Pt Augusta – Whyalla
- Broken Hill – Crystal Brook
- Tarcoola – Alice Springs (long term lease to Asia Pacific Transport, operators of the Alice Spings – Darwin Railway)
- Parts of the Adelaide metropolitan track between Dry Creek and Outer Harbour.

In Victoria, ARTC leases the two mainline interstate standard gauge corridors from the Victorian Government, being:

- Melbourne – Wolseley
- Melbourne – Albury

ARTC also manages access to the connection from the interstate mainline network to the Appleton Dock precinct in Melbourne.

Over these corridors, ARTC is responsible for:

- Selling access to train operators
- Development of new business
- Capital investment
- Operational management
- Management of infrastructure maintenance

The remainder of the interstate network is still controlled by various State Government agencies or private entities, as follows:

- Brisbane – Sydney (Queensland Rail (QR)/Rail Infrastructure Corporation (NSW))
- Sydney – Broken Hill (via Lithgow and Cootamundra) (Rail Infrastructure Corporation (NSW))
- Sydney – Albury (Rail Infrastructure Corporation (NSW))
- Kalgoorlie – Perth (WestNet Rail, track manager subsidiary of the privately owned Australian Railroad Group (ARG) which has a long term lease arrangement with the West Australian Government)

The IGA provided for ARTC to negotiate wholesale access arrangements with each of the track managers described above, which would give ARTC exclusive right to sell access for interstate operations within these jurisdictions.

To date, ARTC has negotiated an agreement with the West Australian Government (assigned to WestNet Rail) that gives ARTC such exclusive rights with respect to new agreements or the novation of existing agreements. WestNet Rail still effectively controls the maintenance, investment and operations between Kalgoorlie and Perth. As yet, no operations are being conducted on this part of the network pursuant to an access agreement developed under the wholesale arrangements.

ARTC has been unable to develop satisfactory wholesale agreements with the track owners in NSW or Queensland. In order to gain greater control over the management of the key north-south corridors, ARTC, with the support of the Australian Government, has recently entered into a long term arrangement with the NSW Government, which will effectively give ARTC the same control over the interstate network in NSW as it has on its own network and deliver the same continuity of access management on the north-south corridors, as currently applies to the majority of the east-west corridors. The arrangement will also deliver to the interstate north-south corridors significant performance benefits designed to improve rail's competitiveness on these corridors and bring about substantial modal shift, through the investment of $870m in targeted improvements on these corridors. These improvements are designed to achieve the outcomes contemplated in the Interstate Rail Network Audit undertaken by ARTC on behalf of the Australian Government in 2001. The lease also gives ARTC control over the Hunter Valley rail network in NSW, which primarily supports the significant Hunter Valley export coal industry.

ARTC's lease of these parts of the NSW rail network will commence in September 2004.

Further investment in the interstate rail network has recently been announced by the Australian Government as part of its new AusLink framework, included a $450m grant to ARTC primarily directed at improving the performance of the interstate rail network between Sydney and Brisbane, and around $500m with respect to specific investments relating to other parts of the interstate rail network.

Under the IGA, ARTC was required to submit a voluntary access undertaking in accordance with Part IIIA of the Trade Practices Act (1974) (TPA) to the Australian Competition and Consumer Commission (ACCC). An undertaking was submitted by ARTC in January 2001, and approved by the ACCC in May 2002. The undertaking applies to the interstate network controlled by ARTC, and sets out the framework under which access to that network can be negotiated with ARTC in a fair and balanced way. In endorsing ARTC's access undertaking, the ACCC recognized that a large part of ARTC's revenue is derived from rail operations that compete in markets subject to strong intermodal competition, particularly road. The ACCC also indicated that it saw ARTC's access undertaking as laying a foundation for the development of a consistent 'national' rail access regime in conjunction with other state based jurisdictions.

It is ARTC's intention, following commencement of the lease in NSW, to develop an access undertaking for ACCC endorsement relating to the existing ARTC network, as well as the interstate and Hunter Valley rail networks in NSW. Until endorsement is achieved, access to the rail network in NSW will continue to be governed by the existing NSW Rail Access Regime, a state based regime not certified by the National Competition Council (NCC) for the purposes of Part IIIA of the Trade Practices Act 1974 (TPA).

Access to the interstate network in WA is currently governed by a state based access regime (also not certified by the NCC), whilst there is no applicable regime with respect to access to that part of the interstate network in Queensland. This infrastructure is not within the scope of the current QR Access Undertaking approved by the Queensland Competition Authority (QCA). As such, these parts of the interstate network are potential subject to possibly of declaration under the TPA, which would effectively take the negotiation of access away from the umbrella of the state based regime, and within the arbitration powers of the ACCC under Part IIIA of the TPA. Whilst state based regimes share a number of common threads with ARTC's access undertaking, there are still fundamental differences (including the identity of the regulator/arbitrator and pricing approach) that add to the difficulty of obtaining access to the interstate rail network.

ARTC's Approach

In order to achieve a key objective of increasing utilization of the interstate rail network, ARTC has adopted a strategy of growing the use of rail for the movement of interstate freight in Australia by improving rail's competitiveness within the broader freight transport logistics framework. ARTC can only assist the industry in this way within the context of its role as a track manager, currently of only part of the interstate rail network, but soon to a greater extent. Rail's competitiveness is also a function of the activity of rail transport operators (ARTC's customers) and the extent to which rail is able to effectively integrate and communicate with other elements of the transport and distribution supply chain within various interstate and international transport markets.

ARTC's corporate mission statement is:

'Through innovation and creative strategies, satisfy our customers, expand the industry; provide efficient access, across modes, to the interstate network; and assist in the development of an integrated national transport logistics network."

ARTC's strategy for improving rail competitiveness is largely built upon the following aims:

- increasing the reliability of interstate rail transport
- reducing interstate rail transit times
- reducing the real cost of access to the interstate rail network
- increasing the level of above rail competition on the network
- increasing the degree of consistency in the application of access and safety regulatory frameworks on the interstate rail network.

To date, ARTC investment and maintenance program, and its approach to pricing and access, have largely been focused on achieving these aims.

The impact of NCP on interstate rail freight transport

The market and competitive environment on the interstate rail freight transport is quite different on different parts of the network. Specifically, the interstate rail freight network could be segregated into two separate, but related, parts servicing the east-west long distance markets between the eastern states and South Australia and Western Australia, and north-south markets in Victoria, NSW, Queensland, South Australia (and, to some extent, Tasmania).

Rail generally operates in direct competition with road with respect to most interstate freight markets, although sea transport (particularly east-west) is growing. Rail's intermodal competitiveness (vis-à-vis road) in the east-west and north-south markets is described in Table 1.

Table 1

Markets	Length of Haul/Corridor	Relative Rail Service Level	Relative Rail Price	Rail Market Share
East – West	Medium/Long haul NSW/Qld/Vic/SA – WA NSW/Qld – SA	Comparable transit time and reliability to road	Around 30-40% less than road	70-80%
North - South	Short/Medium Haul NSW-Vic/Qld Vic-Qld Vic-SA	Inferior transit time and reliability to road	Comparable to road	10-30%

It can be inferred from Table 1, that intermodal competition from road is stronger in the north-south markets than on the east-west markets. This re-enforces the view that rail has a natural cost advantage over road for longer haul journeys (over 1000kms).

During the early 1990's, rail's market share of the eastern states to Perth land freight transport market fell from around 75% to 65%. Around mid-1995, competition in the above rail markets on the Melbourne – Adelaide - Perth corridor commenced with the introduction of services by TNT and Specialised Container Transport (SCT) in competition to the incumbent government owned operator National Rail Corporation (NR).

On the east-west corridors (Brisbane/Sydney/Melbourne/Adelaide – Perth), where ARTC has greater control over infrastructure performance, ARTC has strategically invested in infrastructure improvements designed to reduce rail transit times and increase service reliability (longer crossing loops, capability for heavier axle load operations) as well as enable more efficient above rail operations. On these corridors rail transit time has reduced (by around 2.5 hours, Melbourne – Perth), and service reliability has increased since 1997. Operators have been able to improve above rail productivity (running longer heavier trains) which has resulted, in combination with a real reduction in access pricing since 1998, in a real reduction in cost of access on the ARTC network of 23%. There is little doubt that the more productive use of the rail infrastructure, improved above-rail productivity, improved service levels and greater product differentiation has been driven by above-rail competition on the Melbourne – Adelaide – Perth corridors. This has, in turn, seen cost benefits passed on the rail users through freight rate reductions in the order of 30-40%, and increased rail market share to over 80%. This has meant a reduction in the use of road by around 350 journeys per week across the country than otherwise might have been the case.

Similar improvements have not been achieved on the north-south corridors. ARTC considers that the main reasons for this include the quality and capacity of rail infrastructure and lack of investment, lack of terminal capacity in major capital cities, and a lack of any significant above rail competition.

Key barriers to entry and investment in the above rail market on the interstate network, particularly in north-south markets, are considered to be:

- Lack of available capacity (paths, rollingstock, terminals)
- Lack of competitive neutrality (road/rail, government/private)
- Multiple jurisdictions – leading to inconsistency of operational and safety requirements between states
- Strong intermodal competition

Over the past several years, the height of some of these barriers has come down. The gap between the cost of infrastructure between road and rail has reduced, major government owned operations have now been privatized and some progress has been made towards achieving greater operational and regulatory consistency between jurisdictions. On the other hand, lack of available market preferred pathing, terminal space in or near capital cities, and rollingstock continues to deter new entry and above-rail competition.

With respect to access to the intrastate network in each state, which provides feeder services to the interstate network, an additional deterrent to competition continues to be the industry structure put in place by state governments. Regional networks in most states (except NSW where a vertically separated track owner has jurisdiction) are still vertically integrated. There is no significant above rail competition on regional networks in Queensland, Victoria and South Australia, despite the existence of state based access regimes in each of these states. The only significant regional above rail competition has been in southern NSW (grain) and the Hunter Valley coal network.

ARTC is of the view that NCP, in concert with other policy directions, has resulted in substantial benefits on the interstate rail freight network, despite the presence of road competition. Those markets where other barriers to competition are relatively low (industry structure, intermodal competition, favourable economics, available capacity) have seen a stronger intrusion by new entrants, greater competition and substantial triple bottom line benefits. Conversely, other markets have only seen minimal benefits from NCP.

Over the last few years, there have been some significant changes with respect to the competitive landscape on the interstate rail network. By far the most significant has been the purchase by a Toll/Patrick consortium of the assets of National Rail Corporation (government owned dominant interstate rail freight operator) and FreightCorp (NSW government owned freight rail operator) to form Pacific National. The purchase represents a significant concentration of the market in the hands of one entity. Four previous competitors in the interstate rail network (Toll, Patrick and NR in east-west markets, and FreightCorp in north-south markets) have amalgamated to leaves only two significant competitors (PN and SCT) in the east-west markets and only PN in north-south markets. PN controls over 80% of the standard gauge rollingstock fleet, the substantial majority of intermodal terminal capacity in all Australian capital cities, practically all market preferred pathing on the interstate network whilst joint owners Toll and Patrick have control over significant assets with respect to capital city and regional port facilities, and road transport. Pacific National is also the dominant operator of all regional rail freight movement (coal/grain) in NSW. There has been a degree of competition for grain haulage between southern NSW and the Victorian ports between PN, Australian Transport Network (ATN) and Freight Australia (FA).

PN also provides 'hook and pull' services for the interstate passenger operator, Great Southern Railway (GSR).

Prior to the purchase, ARTC expressed some reservations to the ACCC regarding the impact that the sale may have on the competitive framework in the interstate rail network, and specifically with the concentration of control of most strategic assets (terminals, rollingstock, paths etc) needed for entry to, and competition on, the interstate rail network. The ACCC permitted the purchase (subject to certain conditions, including the sale of some surplus assets back into the market) on the basis that it saw road as providing a constraint on any use of market power by PN. The subsequent sale of surplus assets was a closed sale to an entity with commercial ties to PN.

Having said this, ARTC also saw the purchase by Toll and Patrick, both integrated into downstream markets as representing a significant opportunity for interstate rail transport to become further integrated in national logistics chains in an efficient manner, so improving the competitiveness of interstate rail freight.

During the first year following the purchase, ARTC noted some deterioration in service reliability on its part of the interstate network as PN sought to maximize other aspects of its business (e.g. holding back departure from schedule in order to maximize loading on a train). ARTC also noted increases in freight pricing particularly on long haul corridors, reversing a previous downward trend in pricing.

In 2003, FA entered the north-south interstate above-rail market, commencing a small freight operation between Melbourne and Sydney.

More recently, further aggregation of the above-rail market has, or may shortly, occur where PN have acquired the assets and business of ATN, and have sought to acquire the assets and business of Freight Australia (subject to ACCC and Victorian Government approval). These acquisitions will further entrench PN's dominance with respect to the interstate network, and also with respect to regional markets (grain) in south-eastern Australia. The FA acquisition, in particular, would:

- remove FA as a new competitor in north-south markets.
- deliver control of FA's Melbourne terminal at North Dynon to PN which, in addition to its own facilities at South Dynon, would give PN control of all intermodal rail terminal facilities in the Melbourne metropolitan area, strategically located to the Melbourne port precinct.
- increase PN's control over standard gauge rollingstock to around 90%
- effective ownership of the rail link to the Melbourne ports, in addition to Patrick's control over significant facilities at the port.
- control over the regional broad gauge network in Victoria.
- control over 'hook-and-pull' services provided to PN's remaining competitor in east-west markets, SCT.

Whilst ARTC has no issue with a sale of FA brought about by market forces per se, there is some concern with the impact on above-rail competition in the interstate rail freight market, and south-east Australian regional markets, of control of these strategic assets in the hands of one entity.

Should the purchase proceed, the above-rail market on the interstate network will consistent of two major potential plays, PN and Queensland Rail (a predominantly bulk haul, but with aspirations in the interstate non-bulk market); a smaller, but significant player, Australian Railroad Group (a predominantly bulk hauler); as well as SCT and a number of other relatively small players.

In 2004, Queensland Rail commenced a small interstate service between Brisbane and Melbourne.

ARTC is of the view that recent and significant aggregation of the above-rail interstate market and some regional markets and the concentration of control of strategic assets in the market will substantially affect the ease of entry into these markets, and consequently the future potential for competition. This may erode some of the previous benefits gained, particularly where the strength of intermodal competition (road) is not as great.

A healthy above-rail competitive environment in accordance with NCP objectives represents an important component of ARTC's strategy for long-term asset sustainability. ARTC will continue to create a below-rail environment, through innovative pricing and investment strategies, which promote market entry and efficient competition, as well as explore opportunities to reduce barriers to competition on the network.

NCP – Opportunities for future gains/improvements

ARTC has previously made submissions to the Productivity Commission with respect to the following inquiries.

- 'Review of the National Access Regime' (2001)

- 'Progress in Rail Reform' (1999)

In submissions with respect to the former inquiry, ARTC presented its views and suggestions with respect to ways in which NCP, as embodied in the National Access Regime, could be improved so as to promote efficient competition, encourage investment, and deliver substantial benefits.

The major issues raised by ARTC in its submissions were as follows:

- ARTC is of the view that there should be a single adjudicator with respect to regimes for access in Australia.
- ARTC is of the view that the differentiation of access regimes should be on the access providers' market and industry position
- ARTC is of the view that Industry Codes should be able to be departed from by an access provider as long as it can be demonstrated to the ACCC

that the proposed regime satisfies the requirements of an access undertaking.

A single adjudicator with respect to regimes for access in Australia.

In its submissions, ARTC indicated that it considered the current framework of having two separate national regulatory bodies adjudicating on access regimes as being inefficient and contrary to the principle of having an even playing field in like industry sectors. It proposed that the assessment of all access regimes involving industries whose operation has national implications should solely be a matter for the ACCC. Having a single adjudicator would significantly enhance the achievement of the aims of NCP by enabling the application of a consistent set of competitive principles across all regimes, the provision of a more coherent framework for the identification of markets, and the provision of a consistent framework for the application of access principles with like sectors regardless of the ownership of the access provider.

Differentiation of access regimes should be on the access provider's market and industry position.

The Commission noted that there were two schools of thought regarding the sort of essential facilities that access regulation should cover. That is, the 'Hilmer' model which contended that only vertically integrated facilities should be covered, with other monopoly power issues addressed through other forms of prices oversight, and the current approach which contends that coverage should be based on the facility's bottleneck position in the market rather than whether or not it is integrated into adjacent markets.

In its submissions, ARTC proposed that there should be differentiation between access regimes based on the access providers' market and industry position. Specifically, the characteristics of an access regime are different when applicable to a service provider related to entities operating in upstream or downstream markets vis-à-vis a provider with no such interest, on the basis that the commercial motives of the two providers are different and such motives governed the way the providers operate. Secondly, the characteristics of an access regime differ where the extent to which provision of services utilizing a natural monopoly facility confers market power on the provider of the services.

In its submissions, ARTC proposed two types of regime. A **third party** access regime applicable in circumstances where the access provider is related to entities with upstream or downstream market significance (vertically integrated) is more prescriptive and covers a range of issues including access application, negotiation and pricing, dispute resolution, service performance, anti-competitive conduct, accounting separation and ringfencing. This is necessary to minimize the anti-competitive behaviour that such an entity has a commercial imperative to engage in. An **open** access regime would apply in circumstances where the access provider has no upstream or downstream interests, has access revenue as its principle source of income and has a commercial imperative to promote competition in the use of the facility in order to grow the market. The primary regulatory concern here relates to monopoly pricing, where the provider has market power.

Within each of the two types of regimes, the extent of issues covered and the degree of prescription is largely dependent on the extent of market power that the access provider has. A highly prescriptive third party regime would be applicable with respect to a vertically integrated provider with significant market power. On the other hand a flexible open access regime (or no regulation at all) would be applicable to a separated provider with little or no market power. Figure 1 below illustrates.

Figure 1

Market Power / **Structure**	**Significant** →	**None**
Vertically Integrated	**Third Party Access Regime** Highly Prescriptive Focus on anti-competive behaviours and monopoly pricing	**Third Party Access Regime** Highly Prescriptive with respect to anti-competive behaviours. Less prescriptive with respect to pricing.
Vertically Separated	**Open Access Regime** Only prescriptive with respect to denial of access and monopoly pricing.	**Open Access Regime** Little or no prescription

A formal differentiation of regimes in Part IIIA will create more efficient outcomes in that regimes could be tailored to specifically address the market and industry position of the provider. Further, unnecessary costs of regulation can be minimized.

Departure of regimes from an Industry Code

Industry codes are developed by incumbent industry participants, and can result in a regime that is designed to preserve the current industry structure and competitive positioning. Principles included in Part IIIA should seek to prevent this from occurring. The use of a single adjudicator of access regimes will further support this approach.

The Commission has proposed that Part IIIA should specify that access prices should (among other things) generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services (including a return on investment commensurate with the risks involved), and should not be so far above costs as to detract from efficient use of services and investment in related markets. Whilst it is reasonable that the commercial interests of an existing access provider be protected in this regard, inextricably linking access pricing to costs may serve to prohibit more entrepreneurial approaches to pricing where market growth is seen as a means to mitigate pricing risk. This may be the case with respect to new assets, with substantial capacity shortfall, where the access provider may seek to take market risk by offering initial market based pricing to encourage utilization of the asset.

An intending participant seeking to apply a more entrepreneurial approach to pricing and access with respect to a new asset should have the option of falling in under an existing industry code, or applying for approval of a separate undertaking to the ACCC. A separate undertaking would be considered by the ACCC in the light of all public submissions (including those of incumbent market participants) and assessed on its own merits. On the other hand 'coverage' (in the case of the gas industry) is merely assessed against similar criteria to that for declaration under the Act.

ARTC proposes that Part IIIA should include pricing principles that do not preclude the more entrepreneurial approaches to access pricing which see the access provider voluntarily take on commercial risk with respect to a new asset with substantial excess capacity, in order to promote growth. Further, ARTC is of the view that Part IIIA should not permit an industry code to give incumbent participants the ability to seek coverage of rival assets under the existing code, which may not be geared to provide for market growth based approaches to pricing, where a prospective provider is willing to take on additional market risk. Such a provider should have the option of falling under an existing code or seeking approval of a separate Part IIIA undertaking by the ACCC.

In summary, ARTC fully supports the Commission's position that Part IIIA should provide the lead as a framework for access regimes by creating pressure to eliminate unwarranted differences in individual access arrangements and by encouraging regimes to replicate desirable features of the national regime, which should not inhibit entrepreneurialism. ARTC believes that a provider should have the option of seeking ACCC approval of a separate Part IIIA undertaking or falling under an existing code. If this were not achievable, a preferable solution to closing off the undertaking option within the generic regime would be to modify industry regimes to bring them into line with Part IIIA to the extent that double regulation or duality of access routes might be undesirable.

Further detail regarding ARTC's position with respect to these issues, as well as other issues raised in these inquiries can be found in the submissions held by the Commission.