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 received public submissions in response to its Issues Paper, and has subsequently released a Discussion Draft in October 2004, to which further comments are sought.

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. It commenced operations in 1998 and is now responsible of access and management through ownership, long term lease, or under wholesale arrangement, of the interstate rail network between the Queensland border and Perth, the Hunter Valley rail network in NSW, as well as certain other secondary routes in NSW.

ARTC has provided further detail as to its role, charter, objectives and approach in the previous submission to the Productivity Commission. The previous submission also alluded to ARTC's pending long term lease arrangement with the NSW Government, of the interstate and Hunter Valley rail networks in NSW. ARTC commenced operations in NSW on 5 September 2004. This arrangement will 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 over $500m in targeted improvements on these corridors. ARTC has also received a $450m grant from the Australian Government, which it is intending to invest to further improve the performance of the interstate rail network between Sydney and Brisbane. The Australian Government has also announced, as part of its AusLink framework, commitment to investing a further $550m in rail, primarily focused on improving rail linkages in metropolitan areas.

In the previous submission, ARTC outlined the impact of National Competition Policy (NCP) on interstate rail freight transport. It suggested that far greater improvement in rail efficiency and service levels had been achieved on the longer haul rail corridors (eastern States – WA) than had been achieved on shorter haul corridors on the east coast. This was due to a range of factors including different market economics and the strength of intermodal competition, the condition of, and investment in, the infrastructure, continuity of management, as well as the degree above rail competition. This resulted in a significant increase in rail market share of the land transport market on the eastern states to WA corridors (65% in 1995 to 81% currently), with little or no improvement on north south corridors.

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

ARTC indicated that it was 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.

ARTC also indicated that it was 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 promotes market entry and efficient competition, as well as explore opportunities to reduce barriers to competition on the network.

With regard to NCP generally as well as opportunities for future gains/improvements, ARTC raised three key issues (that had also been raised in previous submissions to the Commission 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.

There appears to be little discussion in the Discussion Draft on these issues. ARTC would recommend to the Commission that further consideration of these measures be undertaken, particularly in the context of further opportunities for significant gains to the economy from removing impediments to efficiency and enhancing competition. ARTC considers that all of measures could potentially improve the framework for healthy competition, promote investment and reduce regulatory cost to industry where appropriate.

The Discussion Draft

Broad conclusions of the review were:

- National Competition Policy (NCP) has brought substantial benefits by way of increased productivity to underpin strong growth in household incomes; reduced goods and services prices, particularly for business; expanded product differentiation; and has helped meet some environmental and social goals.
- The benefits of NCP have, overall, greatly outweighed its cost.
- While some smaller regional communities have been adversely affected, producers, consumers and communities in many parts of country Australia have benefited.

- Most NCP adjustment costs have been incurred whilst benefits should be ongoing.
- Whilst economic performance has improved, there is both the scope and need to do better going forward.
- Energy and water remain priorities for continued reform.
- Nationally coordinated reform frameworks should be developed for freight and passenger transport.
- A more targeted framework of legislation review is needed.
- High priorities for nationally coordinated reform are health care and natural resource management.
- Successful implementation of a new reform agenda will depend crucially on achieving inter-jurisdictional support on arrangements that:
    - Clearly spell out objectives and principles
    - Facilitate the analysis required to develop well-founded specific reform options
    - Provide for independent monitoring of progress in implementing changes
    - Embody robust mechanisms to prevent back sliding.

The Commission had made a number of proposals specific to the transport sector as well as a number of broader proposals that ARTC considers are particularly relevant to activities in the transport sector. ARTC comments will largely focus around these particular proposals.

Proposals and findings specific to the freight transport sector include:

- Governments should complete all outstanding freight transport matters under the NCP legislation review program

- CoAG should sponsor the development of a longer-term strategy for achieving a national freight system that is neutral across transport modes

- As an immediate priority, CoAG should sponsor the development of a national reform agenda for the rail sector that integrates current work in this area and establishes clear timelines for implementation of reform.

- Progress towards a transport system where decisions on the means of transport are based on the intrinsic efficiency of the different options, rather than on government policies and regulations that favour one mode of transport over another

- Undertake the scheduled review of cabotage, unless this is addressed as part of a wider review of coastal shipping.

A proposal specific to the passenger transport sector:

- CoAG should commission an independent national review of the passenger transport sector to assess the impacts of recent reforms and determine what is now needed to deliver further performance improvements in both urban and regional areas.

Another broad finding that has particular relevance to the freight and passenger transport sectors include:

- More should be done to ensure that pricing regimes for regulated infrastructure services give appropriate incentives to providers to properly maintain facilities and to advance and augment networks.

Rail Freight Sector

With regard to the freight transport sector generally, ARTC supports the Commission's position that further pricing, access and regulatory reform is needed to achieve a freight transport system that encourages an efficient mix of transport modes and provides for seamless movement of freight along entire logistics networks. ARTC considers that objectives for future ongoing reform include addressing a range of impediments to the efficiency of intermodal freight transport and logistics including:

- Unbalanced policy development & investment decisions
- Ongoing certainty of land use arrangements
- Differing accreditation schemes
- Lack of transparency and equity in road pricing versus rail
- Terminal and track access
- Infrastructure and equipment investment certainty and incentive
- Exchange of information
- Use of non-standard equipment
- Coordination of working arrangements
- Infrastructure quality
- Industry training

Many of these impediments have been recognized by the industry in previous assessments undertaken by industry and regulatory bodies. ARTC understands that not all impediments can be addressed through NCP. Many will rely on the industry itself to resolve in response to domestic and international market pressure.

ARTC has stated previously that it considered that NCP had resulted in significant benefits to the rail freight transport industry generally, users and the wider community. The industry, given the nature of the markets that it serves, is inherently complex. Complexities are expected to increase in the future as the industry seeks to better position itself within a more diverse range of broader transport logistics networks. ARTC considers that rail can be an effective contributor and add value to these networks going forward given the correct policy settings, investment in capacity and efficiency of interfaces with other parts of these networks going forward.

Within existing freight transport markets and networks, improvements in efficiency, flexibility and service levels over the last ten or so years has been variable. This variability has resulted from a range of factors, of which NCP is one. Other factors impacting on the extent to which rail has been able to improve its performance and competitiveness include:

- Underlying economics of rail freight transport and competing modes
- Market and industry structure, including vertical and horizontal integration
- Ownership
- Integration and interfaces with other transport modes
- Government policy settings
- Level of investment in infrastructure and capacity

A number of these factors influence the height of entry barriers to new competitors and have, to varying extents, constrained the results on competition of the application of NCP and its mechanisms such as third party and open access regimes.

ARTC considers that the interstate rail freight sector has benefited significantly from the advent of competition for services by way of lower costs, more efficient operations, and improved service levels. ARTC has previously pointed out that, even in the interstate rail freight sector, different settings and changes in the above factors have had different outcomes to date on different parts of the interstate network.

On east west corridors, there have been significant improvements in rail freight transport efficiency, service levels and product differentiation brought about by increased above rail competition and investment that have resulted in a significant transfer of freight from road to rail and the well documented accompanying community benefits. In these markets, many of the above factors are set to favour, or at least minimize the negative influence on, the introduction of new entrants and the development of sustainable competition. For example the length of haul on east west freight corridors provides rail with a natural cost advantage, the rail network is largely vertically separated which is more likely to encourage open access and competition at lower transactional cost, infrastructure management is largely unified enabling more consistent conditions for access, infrastructure quality is acceptable and infrastructure investment has been focused around improving rail efficiency.

On north-south corridors, short hauls reduce rail's cost competitiveness, infrastructure management is fragmented, the infrastructure suffers from historic under-investment resulting in inferior performance and limited capacity, policy settings constrain rail freight performance (passenger priority in urban areas), and there is limited terminal capacity and availability in east coast urban areas. As a result, only limited competition has eventuated on north-south corridors, which, in the past has been extinguished by industry consolidation in the above rail market, where one player dominates north-south rail markets including rollingstock, train paths, and urban terminal space. In recent times, a further competitor in the north-south intermodal market has emerged (Queensland Rail). ARTC, through its lease on the interstate network in NSW commencing 5 September 2004, is intending, through improving management and substantial infrastructure investment to facilitate improvement of these settings and promote further above-rail competition on north-south corridors. ARTC continues to support the position held by the Commission that vertical separation of train operations from track infrastructure, and horizontal management of the network is appropriate on the interstate rail freight network.

With regard to high volume regional networks (publicly owned infrastructure) there is little doubt that NCP has resulted in significant efficiency and service level benefits, and improved competitiveness, for industry supported by these networks. Coal networks in both NSW and Queensland have both been subject to significant competitive reforms. Both of these rail networks are highly integrated with other elements of their respective supply chains (mines, ports) and have different industry structures both in terms of separation and ownership. NCP, through, price setting mechanisms inherent in state based access regimes, has significantly reduced access costs and pricing on both networks. The first above rail competition on these networks is due to commence in 2005, when QR commences operations on the Hunter Valley rail network in NSW. Once again, ARTC contends that the quantum and type of benefit from NCP on these networks is influenced by the settings of other factors (particularly government policy setting in this case). All of this would support the Commissions position that for high volume regional networks, vertical separation or integration may be appropriate in different markets.

The performance of low volume regional networks (in particular, branch lines to service regional agricultural markets) has experienced the least improvement over the last ten years, despite significant changes occurring with respect to the structure and ownership of transport services and grain markets generally. The application of NCP has given rise to the privatization of many of these lines, vertical integration in most states, but very limited competition for rail services (which has been quickly extinguished through market consolidation in all cases). Again, ARTC considers that the poor performance and current state of the infrastructure and rollingstock assets on branch lines is a result of a range of factors, many historic, rather than through the introduction of a competitive framework on branch lines.

Even though rail is operationally a better technology for the movement of grain from regional areas to port, the underlying economics of rail on branch lines is such that rail cannot compete effectively with road for grain on many branch lines, even on lines where the longer haul suits rail, on a sustainable basis. This situation is exacerbated by the non-transparent and inequitable pricing of competing road infrastructure compared to the rail line. Branch line infrastructure is a dedicated, expensive high fixed cost asset not particularly well suited to markets that suffer from significant variability both within and between seasons. Further, the broader grain handling and marketing industries have sought to improve operational efficiency by rationalizing patterns for grain transport and storage by introducing larger, more efficient storage and handling facilities on main lines, so offering growers more attractive alternatives to traditional movements from the farm to a local silo.

The economics of grain branch lines are such that many lines have not been conducive to asset renewal and investment by owner for a number of years. This was the case when these lines were (and in some cases still are) in government ownership. When grain branch lines were privatized, they often came with a significant embedded maintenance deficit making the now significant investment in lines, now privatized, is even less likely given returns sought by private shareholders. There is a need for governments to intervene to assist in correcting the acquired deficit or recognizing the use of road in these areas.

Historically, vertically integrated, government owners of rail branch lines, not exposed to significant competition were able to cross-subsidise the costs and inefficiencies of branch lines. Economic reform with respect to infrastructure in the rail sector has exposed these cross-subsidies and inefficiencies, meaning that grain branch lines have had to stand-alone. Similar reforms have not occurred in the road sector where cross subsidization of local and arterial and rural and urban roads still exists.

It has been said in some quarters that the inability to cross-subsidise low volume regional lines that has resulted from NCP (and the threat of above rail competition) has been the cause of the deterioration in performance and returns from these lines, and the current plight of regional branch lines in many states. In all states there has been little sustained competition so it is difficult to imagine that this may have caused the current under-performance. ARTC has sought to demonstrate through its argument above that there are a range of factors involved that should, in combination, be considered as the main contributors to the current situation.

ARTC considers that an appropriate response to the under-performance of grain branch lines would be to:

- Recognize and concede that some low volume older lines do need to be rationalized and support road infrastructure to allow trucking of grain to more efficient larger consolidation facilities near more economic grain lines.
- Where appropriate, governments should intervene to assist in correcting the acquired deficit.
- Address the current lack of transparency and equity between road and rail pricing in regional areas so that both modes can compete on a level playing field.
- Address the current imbalance where regulatory practice has focused more-so on efficient service provision than on investment for longer-term sustainability and capacity. A re-balancing is required in this regard rather than withdrawal of regulation.
- Re-consideration of the most appropriate structural model with respect to grain branch lines. The Commission supports a vertically integrated structure in this regard.

Competitive Neutrality

The Commission has indicated that it considers achieving neutrality between transport modes as a longer term objective. Incorporating externalities in investment appraisal and pricing frameworks is complex and requires further development whilst, although technology is rapidly extending the possibilities of more specific pricing, such as individual user pricing, for cost and technical reasons, 'most of Australia's network will remain 'unpriced' for the foreseeable future[1]'.

[1] P184 of the Discussion Draft

The National Transport Commission (NTC) is presently considering options for improving the accuracy of, and equity in, the recovery of road expenditure for types of heavy vehicles as part of its 3rd Heavy Vehicle Road Pricing Determination due to be implemented in 2006. The Commission has indicated for similar reasons to those above that it will not be considering 'individual pricing' (some form of mass distance charging of individual vehicle use based on vehicle tracking and weighing technologies), as well as the incorporation of externalities. In submissions to the NTC, ARTC has expressed disappointment in this position as it does not seem to make any progress on these issues from what was the case with regard to the 2nd Determination in the mid 1990s.

ARTC proposed that an incremental adoption of these measures should be considered in the 3rd Determination, at least to address the lack of neutrality of road and rail pricing, where rail competes with only a relatively small part of the heavy vehicle fleet.

ARTC asserted that, in the interests of pursuing competitive neutrality between the road and rail modes, as well as achieving equity in charging for different road users, it was imperative that the NTC rectify inadequacies in its cost recovery and allocation processes in the 3rd Determination. This should be done as a matter of urgency, even if significant improvements in the areas of individual pricing and incorporating externalities cannot be achieved within the timeframe.

Investment Incentives

ARTC fully supports the Commission's proposal that 'more should be done to ensure that pricing regimes for regulated infrastructure services give appropriate incentives to providers to properly maintain facilities and to advance and augment networks'.

In many parts of the rail freight sector, significant gains have been made over the last 10 years though improved operating efficiencies and lower cost structure whilst maintaining or improving the level of service quality and flexibility (as described above). This has resulted in significant benefits to users of the network, end market users and the community generally. This is evidenced by the number of major logistics companies with an appetite for greater involvement in the rail freight sector, directly or indirectly, with a view to leveraging and further improving on the efficiencies already made, and integrating rail into their wider logistics networks.

The freight transport sector is forecast to grow significantly over the next 20 years. For rail to compete and retain or improve its share of this growth, resulting in many indirect benefits for the Australian community, significant investment in the performance of the infrastructure will be needed, among other things (described above). Despite much improved efficiencies in the sector, it is still generally accepted that there has been significant under-investment in rail infrastructure to improve performance and increase capacity on large parts of the network. This situation has not been significantly improved by the application of NCP and accompanying structural, ownership and competitive outcomes on the network.

On the east west interstate corridor, ARTC has strategically invested with the aim to improve interstate rail service levels (reliability and transit time) as well as improve operator yield by operating more efficiently (longer, heavier trains). The latter has enabled rail to reduce pricing and offer a more competitive price/service package to users. ARTC's variable/flagfall approach to pricing also encourages more efficient utilization by operators by bringing down their unit cost of access for infrastructure ($ per net tonne kilometre).

This also, however, reduces access revenue yield to the track owner. Thus, investment in the network undertaken by ARTC has the effect of reducing the access revenue received per unit of freight hauled. The company is very much reliant on the outcomes of improved service levels and efficient operations being translated into improved rail competitiveness and higher market share and volume to compensate for reduced access revenue yield. ARTC is taking significant market risk in this regard, that is also reliant on strong and sustainable competition for rail services.

On the north-south network, ARTC has gained a lease of the interstate and Hunter Valley networks in NSW. This has given rise to a significant investment program to be undertaken by ARTC on both of these networks to improve rail and supply chain competitiveness and capacity. This investment is also predicated upon significant market growth arising from improved service levels and rail pricing.

It is generally accepted in the rail industry that investment in infrastructure gives rise to the greatest returns to the industry and users. That is, $1 invested in infrastructure delivers greater benefit than $1 invested elsewhere in the logistics chain. However, most of the benefits from this investment are derived by the rail operator, rail user and wider community. The National Audit[2] concluded a distribution of financial benefits of the investment program on the

[2] Interstate Rail Network Audit, Booz Allen Hamilton for ARTC, April 2001.

north-south corridors to be rail operator (38%), rail customer (34%), society (25%) and track owner (3%).

With regard to the Hunter Valley coal network in NSW, NCP has given rise to substantial improvements in operating efficiencies, and removal of previous monopoly rents, to lower transport costs to the industry, and improve its competitiveness. On the other hand, investment in the network to increase capacity in order to take advantage of this increased competitiveness when market conditions are right has not been forthcoming. Growth in coal throughput in the last five years has largely taken up existing capacity. Over the last 2 years, global demand for coal has increased significantly giving rise to higher coal prices and the opportunity for substantial returns to mining companies operating in the Hunter Valley. This demand is expected to continue for at least the next two years.

Over the last twelve months, the coal supply chain has been unable to keep up with this demand, where long shipping queues off the Port of Newcastle, and consequent high demurrage costs to miners, has resulted. To address this, Port Waratah Coal Services (the operators of the coal facilities at the port) have sought and achieved, through the ACCC, to limit the ability of coal miners to service international demand, through the introduction of a quota system. Despite potential anti-competitive ramifications of such a system, it has been approved to operate on an interim basis until 2007.

ARTC considers that the inability of the coal supply chain to keep up with demand is caused by a number of factors, but a common perception is that it is the rail network that is the primary bottleneck. Although not clear, ARTC understands that the previous infrastructure owner did not significantly invest in increasing the capacity of the Hunter Valley rail network because it did not see the returns to it as being commensurate with the inherent risks of investing. Whatever the reason, it would appear that the commercial and regulatory environment in the Hunter Valley did not provide sufficient incentive to invest.

Since its initial lease proposal to NSW in mid 2002, ARTC has proposed, and is committed to, investing around $160m in the Hunter Valley coal network to increase capacity to in excess of 100mTpa (currently around 85mTpa). This is, however, subject to receiving the support of the industry for the investment program and achieving a sufficient return from the investment commensurate with perceived risk, based on regulatory parameters at the time, envisaged in ARTC's NSW lease business case put to the NSW Government. ARTC understands that the industry is strongly supportive of ARTC's investment program. Clearly, if the regulatory framework in place in NSW further constrains investment returns, then the investment program would become less commercially attractive to ARTC, and would require re-consideration.

ARTC would like to draw the attention of the Commission to industry and government response to a recent draft decision by the Queensland Competition Authority with respect to the regulated rate of return to apply to the Dalrymple Bay Coal Terminal in Queensland which highlights the impact that regulatory practice in this area can have on the infrastructure owners ability to invest in increased capacity.

The Commission has previously put forward changes to the National Access Regime that would give greater emphasis to facilitating investment so as to ensure sustainability of service provision over the longer term. These include:

- A binding ruling that the Part IIIA 'declaration' criteria are not met and that, as a consequence, the facility would not be subject to the regime.
- Other mechanisms to facilitate efficient investment within Part IIIA and access regimes more generally, such as fixed access holidays for essential infrastructure that is deemed to be contestable, and provision for a 'truncation' premium to be added to the agreed cost of capital for a facility.

ARTC would be concerned that the first approach may amount to 'throwing the baby out with the bath-water', and would prefer solutions within the Part IIIA framework. Access holidays should be clearly transparent and should only apply to the extent that there is a net benefit. Truncation of returns can exist either where the infrastructure owner is exposed to downside but exposure to upside is capped, or where pricing on parts of a regulated network a constrained (by the market) to less than a 'maximum' return. Where this is the case, ARTC agrees that the application of a premium may have some merit.

The 'balancing' of an appropriate return by the regulator should take into account all of the systematic and specific risks (including the regulatory risk itself) to which an infrastructure owner is exposed and should give some weighting to the benefits accruing to users, customers and the wider community, relative to the infrastructure owner, of capacity enhancing or network augmenting investment. Consideration must also be given to the need for the regulated assets to be able to generate a return that will attract investors to those assets, as well as simply compensate the owner.

ARTC also considers that consideration should also be given to recognizing and rewarding 'soft' investment undertaken by the infrastructure owner, whereby increased network capacity arises from improved and innovative approaches to network management and coordination (often associated with a degree of risk). This often relieves or defers the need for 'hard' investment. The regulatory framework only provides for the owner to recover a return on hard investment, so reducing the incentive for the track owner to invest in innovative thinking and R&D to develop alternatives to investment in hard assets.