



Australian
Competition &
Consumer
Commission

Submission to the Productivity Commission

Draft Report into Road and Rail Freight Infrastructure Pricing

October 2006

Overall View

The Australian Competition and Consumer Commission (ACCC) supports the general thrust of the Productivity Commission (PC) Draft Report: *Road and Rail Freight Infrastructure Pricing*. In particular, the ACCC supports the pursuit of more efficient road and rail infrastructure pricing practices in each mode.

The ACCC acknowledges the PC's note of caution in relation to the possible costs of implementing certain road pricing practices and agrees that careful cost-benefit analysis would be required before committing to any particularly costly new technologies. The ACCC also acknowledges that realising the full benefits of improved pricing practices may require improved institutional arrangements. However, the ACCC expects that there may be gains available from even limited reforms, for example through reducing the degree of averaging present in heavy vehicle charging.

While the ACCC is generally supportive, it has identified the following two matters for further comment.

1 Regulators' roles in efficient rail pricing

The Productivity Commission questions whether regulatory arrangements in rail provide sufficient scope for regulated firms to implement efficient price discrimination. The PC has expressed concern that regulators have not fully embraced the concept of efficient price discrimination and that this can affect cost recovery and incentives for investment.

The relevant sections are:

- **Chapter 3, page 3.5**

'... commercially-operated utilities, such as rail, still may be able, as well as have an incentive, to capture marginal sales through discriminatory (Ramsey) pricing. That said, such pricing, though potentially efficient, may be discouraged or even curtailed by regulators.'

- **Chapter 5, page 5.12**

'... generally, there are potentially efficiency gains from allocating proportionately more common costs to customers whose use is less sensitive to price changes. Preventing pricing based on demand elasticities would therefore be inappropriate from an efficiency perspective (and could affect financial viability). Even though no explicit regulatory prohibitions exist, it appears rail infrastructure owners perceive that regulators may not find such pricing acceptable. Pricing principles such as those recently included in Part IIIA of the Trade Practices Act 1974 would potentially facilitate increased efficiency by explicitly allowing multi-part pricing and pricing based on demand elasticities.'

• **Chapter 10, page 23**

‘...(access) regulations may restrict operator behaviour (for example, by precluding discriminatory pricing strategies) in a manner that may reduce efficiency.’

• **Draft Finding 5.3, page 5.12**

‘While access regimes do not explicitly preclude rail infrastructure providers from allocating proportionately more common costs to less price-sensitive users, it is not clear that the benefits of such pricing are adequately reflected in the approach of regulators.’

The ACCC fully recognises that economic efficiency can be promoted by access prices that discriminate on the basis of differences in the costs of supplying different network users and on the basis of different demand elasticities. The efficiency properties of Ramsey-Boiteux pricing structures are well recognised. Prices set on the basis of Ramsey-Boiteux pricing principles such that they vary inversely with users’ demand elasticities, ensure that the welfare losses associated with departures from marginal cost pricing are kept to a minimum.

However, it is important to recognise that it is extremely difficult to estimate demand elasticities with accuracy and in the absence of competitive or other pressures to ensure that firms implement efficient differential pricing principles across all services, access providers can have an incentive to abuse the freedom to price discriminate. The consequences of setting prices that depart from the welfare-maximising Ramsey-Boiteux structures can result in significant welfare losses. The ACCC noted in a recent access determination that setting prices above the optimal Ramsey-Boiteux level ‘... will result in efficiency losses, and these losses will tend to increase at an increasing rate as the price is increased.’¹

Also, unrestrained Ramsey-Boiteux prices can approximate prices charged by a profit-maximising monopolist practising price discrimination. While the welfare effects of certain types of price discrimination are ambiguous and depend on the prevailing circumstances, such prices generally allow a monopolist to earn larger profits relative to a non-discriminating monopoly outcome. As Scherer and Ross articulate, in certain situations it may be necessary for a regulator to impose limits on demand-based price discrimination:

“...Ramsey pricing invokes the logic of third-degree price discrimination. The agency regulating the natural monopoly could seek to enforce prices such that in any given market i :

$$(P_i - MC_i)/P_i = R(1/e_i)$$

Where R is a Ramsey number with values in the interval from 0 to 1 and the e_i is the price elasticity of demand in the i^{th} market segment. When $R=1$, the outcome in any given market segment is identical to the solution that would be chosen voluntarily by

¹ See ACCC, *Final Decision, Optus Undertaking with respect to the supply of Domestic GSM Terminating Access Service*, February 2006, p. 85. For a full discussion of the issue, see pp. 66-88 of the Final Decision. Decision is available on the ACCC web site at:

<http://www.accc.gov.au/content/index.phtml/itemId/636322/fromItemId/269280>.

price discriminating monopolists. ... Ramsey numbers intermediate between 0 and 1 would be applied when some degree of monopoly pricing is necessary for a natural monopoly to cover its costs, but in which going all the way to the unconstrained monopoly solution would provide more revenue than is necessary.”²

Furthermore, even if applied efficiently, Ramsey-Boiteux prices can distort competition in related markets. Price structures that only reflect the demand characteristics of above-rail firms can favour inefficient above-rail services if these have relatively elastic demand for infrastructure services.

Therefore, in assessing access pricing approaches based on differential pricing, the ACCC would need to be satisfied that prices are either based on differences in costs or alternatively do not damage economically efficient competition in related markets. Among other things, the ACCC would consider a proposal for price discrimination in the light of safeguards that supported efficient outcomes. In the case of rail, the ACCC would look to intermodal competition or, in the absence of competitive disciplines, other appropriate regulatory measures, to give above-rail operators comfort about restraints on the ability of the access provider to apply inefficient differential pricing.

The ACCC also notes that the PC should have regard to the regulatory regime in which an access provider and its relevant regulator operates when allocating responsibility for access pricing outcomes. For example, the ACCC’s role in relation to ARTC arises through a voluntary undertaking under Part IIIA of the *Trade Practices Act 1974*. In that framework the ACCC is required to assess an undertaking designed and presented by the access provider against the criteria provided in Part IIIA. The ACCC can accept or not accept the undertaking but it cannot impose an undertaking of its own choosing. While the ACCC can influence access pricing structures, the pricing behaviours observed in practice will reflect, in part, the access provider’s own pricing strategy.

In its assessment of the ARTC rail access undertaking, the ACCC observed that ARTC’s commitment to providing above-rail operators in the same end market ‘like service at like prices’, represented a restraint on its ability to charge different customers different prices.³ This limited the extent to which ARTC could sell access on the basis of users’ valuations and thus raise revenue that could potentially improve cost recovery. The ACCC noted in its decision that a degree of price discrimination may be a desirable practice, provided it did not distort above-rail competition..⁴

That said, the ACCC understands that there is experience with demand-based price discrimination in Australian rail infrastructure. It is not uncommon to see access prices reflect cost differentials and the different demand characteristics of different types of traffics, such bulk, container freight and passenger traffics.

² FM Scherer and D Ross, “Industrial Market Structure and Economic Performance”, Houghton Mifflin Company, Boston, 1990; p 498.

³ Though ARTC retains some freedom in relation to pricing between traffic types.

⁴ ACCC, *Final Decision, ARTC Access Undertaking*, May 2002; page 100. See also pages 94, 95 and 99. Decision is available on the ACCC web site at: <http://www.accc.gov.au/content/index.phtml/itemId/757019/fromItemId/757001>.

2 Vertical Integration

The PC has recommended a detailed review of allowing vertical reintegration of particular rail lines (Draft Recommendation 11.5) and has requested further information and views about the potential costs and benefits of reintegration on specific networks.

The ACCC notes that the Australian rail industry involves a mixture of vertically integrated and separated rail businesses. This situation reflects historical patterns of government policy and, more recently, commercial transactions.

The most apparent case of vertical separation from a national perspective is the creation of ARTC as the owner/operator of much of the interstate rail network. This separation is the direct result of government policy, which sought to create, amongst other things, conditions conducive to the development of above-rail competition.

The ACCC also notes that further vertical separation has recently occurred in Western Australia (in relation to the Australian Railroad Group and WestNet Rail), this time as a result of commercial decisions.

The ACCC is unable to comment on the merits or otherwise of any specific case of reintegration that might arise. However, the ACCC observes that where a rail line or network gives rise to significant market power concerns then vertical reintegration could increase these concerns.⁵ In such circumstances there would need to be careful consideration of the likely trade-offs between pursuing any economies of integration (which would be, presumably, the public policy reason for preferring reintegration) and the impact of possible reductions in competition that might arise from reintegration. While the latter may be alleviated by access regulation, the task for access regulation is typically more challenging in the case of vertical integration, where the incentives provided to the access provider can lead to a substantial diminution, or even a complete absence, of effective competition. Any detailed review of reintegration would need to assess the risk and cost of such outcomes.

The ACCC also suggests that any review of reintegration should consider the various means of capturing any economies of integration that are thought to be available. Experience, including in the rail and logistics areas, has shown that benefits can sometimes be generated by various information sharing, contractual, co-ordination, co-regulatory or other such arrangements. Limiting the options to either of vertical integration or vertical separation is likely to misstate the possibilities.

⁵ For example, the ACCC stated its views on issues of market power in relation to non-bulk traffic on the east-west rail corridor, which involves ARTC track, in its 5 May 2006 Public Competition Assessment of the acquisition of Patrick Corporation Limited by Toll Holdings Limited: <http://www.accc.gov.au/content/index.phtml/itemId/724185/fromItemId/751043>.