Economic Regulation Authority
WESTERN AUSTRALIA

Level 6, Governor Stirling Tower
197 St Georges Terrace
Perth Western Australia 6000

GPO Box 8469
Perth Business Centre
Western Australia 6849

Telephone 61 8 9213 1900
Facsimile 61 8 9213 1999
Website www.era.wa.gov.au

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10 November 2006

Mr Gary Banks
Chairman
Productivity Commission
Level 3 Nature Conservation House
Corner Emu Bank and Benjamin Way
Belconnen ACT 2617

Dear Mr Banks

**ROAD AND RAIL FREIGHT INFRASTRUCTURE PRICING: PRODUCTIVITY COMMISSION DISCUSSION DRAFT**

Thank you for the opportunity to comment on the Productivity Commission's (Commission) Discussion Draft of the Review of Road and Rail Freight Infrastructure Pricing (Report).

Please find attached a copy of a submission prepared by the Economic Regulation Authority (Authority) on the Commission's Report.

The majority of issues addressed in the Report appear to be more directly relevant to the rail freight infrastructure networks on the eastern seaboard and the interstate east west rail network rather than the WA intrastate regional rail freight network for which the Authority has regulatory responsibility. As a result of the emphasis on the eastern states some of the conclusions that are drawn in the report do not seem to be particularly relevant for the Western Australian regime.

The Authority's view is that the Commission may wish to consider investing resources into collecting disaggregated data in order to carry out analysis at the regional level. This would enhance the analysis, findings and recommendations in the Final Report on road and rail freight infrastructure pricing.

If this is not feasible in the available time, then the Authority suggests that the Commission should consider modifying the draft findings and associated draft recommendations based on analysis of aggregate data to reflect the circumstances which apply at the regional level. This is particularly true for the analyses and findings about cost recovery of road freight in aggregate and the implications for competitive neutrality between types of road trucks (such as B-doubles) and rail for grain haulage.

Should you wish to discuss any of the issues raised in this submission, please contact Mr Russell Dumas, Director – Gas and Rail Access (telephone: 08 9213 1900).

Yours sincerely

LYNDON ROWE
**CHAIRMAN**

Attachments

# Economic Regulation Authority Submission on the Road and Rail Freight Infrastructure Pricing Discussion Draft

## *Purpose*

The purpose of this submission is to bring to the attention of the Inquiry the key features of the economic regulatory regime for rail in Western Australia and to provide the Productivity Commission with comments from the Economic Regulation Authority (**Authority**) on some of the issues raised in the Discussion Draft Report (**Report**) of the review of road and rail freight infrastructure pricing.

This submission is divided into three main sections these being:

- The Western Australian (**WA**) Rail Access Regime.
- General comments on the Report.
- Comments on key issues raised in the Report.

## *The WA Rail Access Regime*

### The regulatory regime and the role of the Authority

The Western Australian rail access regime (**Regime**) is made up of the *Railways (Access) Act 1998* (**Act**) and the *Railways (Access) Code 2000* (**Code**). The Code is a requirement of the Act and both became effective on 1 September 2001 when the regime commenced.

The Authority's role is to oversee, monitor and enforce compliance with the Act and the Code. The rail network and types of infrastructure subject to the Regime are defined in Schedule 1 of the Code.

### Coverage of the Regime

As specified in Schedule 1 of the Code, the railway network covered by the Regime comprises about 5,000 route kilometres of rail track in the south-west of Western Australia. This generally comprises all standard and narrow gauge rail track and associated infrastructure west of Kalgoorlie.

The Regime's coverage does not include the Pilbara region railway lines, the track east of Kalgoorlie (which is owned by the Commonwealth Government and controlled by the Australian Rail Track Corporation (**ARTC**)) and other privately operated rail tracks.

### Floor and ceiling prices

The central feature of the Regime is that it is a negotiate and arbitrate model where the rail track owner and the access seeker negotiate the terms and conditions (including price) of the access arrangement on a commercial basis between upper (ceiling) and lower (floor) price boundaries determined by the Authority. This differs from rail regulation in most other jurisdictions where the regulator sets a reference service and a reference tariff.

It should be noted that rail track users are not compelled to negotiate with rail track owners under the Code but can negotiate on a commercial basis outside the Code. The role of the Code is to act as a safety net to allow the parties to utilise the principles and features of the Code to assist with the conclusion of an access agreement.

### Cost and pricing principles

The pricing principles which govern how access charges are calculated under the Regime are outlined under Clause 13, Schedule 4 of the Code.

The Code does not prevent railway owners from price discriminating in that they can charge different access prices for different rail track users within the floor and ceiling prices determined by the Regulator.

The Regime operates on an efficient cost basis with the floor and ceiling costs based on on a Modern Equivalent Asset (**MEA**) using Gross Replacement Value (**GRV**) as the asset value methodology. These costs are not actual costs of the rail network but rather the hypothetical GRV of a MEA, assuming efficient practices.

The GRV is calculated as the lowest current cost to replace existing assets with assets that have the capacity to provide the level of service that meets the actual and reasonably projected demand and are MEA.

The term MEA has been defined as: "An optimised network that is reconfigured using current modern technology serving the current load with some allowances for reasonably projected demand growth for up to five years into the future. The MEA excludes any unused or under utilised assets and allows for potential costs savings that may have resulted from technological improvement."[1]

### Rail freight business in WA

In December 2000 the freight business of the Western Australian Government Railways was privatised, as a vertically integrated business, under a long term lease agreement to the Australian Railroad Group (**ARG**). In June 2006 the business was sold as two separate businesses with the above rail operations, Australian Western Railroad (**AWR**), sold to Queensland Rail and the below rail business, WestNet Rail (**WNR**), sold to Babcock and Brown. The above and below rail owners continue to trade as AWR and WNR respectively.

The WA Regime freight haulage task comprises:

1) Bulk commodities (i.e. bauxite/alumina, coal, iron ore, mineral sands and nickel) – approximately 80% of the total haulage task;
2) Grain – approximately 15% of the total haulage task; and
3) Intermodal (i.e. containers and other non bulk commodities on the east-west interstate line) – approximately 5% of the total haulage task.

The below rail owner of the freight network (WNR) receives very little contribution from the WA Government. The Government does contribute towards maintenance costs for signalling equipment at level crossings on some rail lines which are primarily for safety.

## *General comments on the Report*

The majority of issues addressed in the Report appear to be more directly relevant to the rail freight infrastructure networks on the eastern seaboard and the interstate east west rail network rather than the WA intrastate regional rail freight network for which the Authority has regulatory responsibility. As a result of the emphasis on the eastern states some of the conclusions that are drawn in the report do not seem to be particularly relevant for the Western Australian Regime.

In addition, the analysis in the Report is of aggregate data and to the extent that there is disparity within the data then the resulting conclusions may not be representative of all rail

[1] This definition is given in the WNR Costing Principles approved by the Authority in August 2006.

networks in Australia, including WA. For example, the Report claims that rail networks do not cover full costs and receive government subsidies. This may be true for some rail networks in the eastern states and the east west ARTC network but is not the case for WA.

## *Comments on key issues raised in the Report*

### Competitive neutrality between road and rail freight

The issues associated with competitive neutrality between road and rail freight are raised at several places in the Report.

The underlying theme of this issue is that road freight is paying its way in that the total costs of road provision are covered in aggregate. However, it is acknowledged in the Report, in a number of places, that there is some cross subsidy between vehicle types within the road infrastructure system.

#### *Report Findings*

The terms of reference for this inquiry emphasise the need for consistent and competitively neutral pricing to promote efficiency in road and rail infrastructure.

The Report explains the concept of competitive neutrality in terms of standard economic principles.

> Draft Finding 8.2 "Achieving the highest-valued use of resources generally requires prices for goods and services being equal to their short-run marginal social costs. This would also ensure that choices are 'competitively neutral'; that is that they reflect relative costs. However, the substantial and lumpy investments and economies of scope involved in road and rail infrastructure are likely to render short-run marginal cost pricing infeasible and possibly inefficient." [p. 8.5]

Road charging is done on the basis of the 'pay as you go' system (PAYGO) with a combination of fuel excise and vehicle registration to cover the cost of providing the road freight services including the cost of road provision.

The Report notes that "Within the PAYGO system of road charging, heavy trucks in aggregate more than cover their assessed costs." [p. xxvi]

However, in a number of places in the Report it is suggested that cross subsidies exist between vehicle classes and between users (e.g. from urban road to rural road). In particular, the Report suggests that B-doubles as a vehicle class is subsidised and does not meet its costs. [pp. xxxvi, 4.1, 4.11, 4.31, 4.32, 4.33, 4.35, 4.36, 4.40, 4.41, 7.1, 7.5]

In chapter four the Report suggests that while in aggregate road freight is paying its way there are some cross subsidies between different vehicle classes.

> Draft finding 4.1 "Under a PAYGO approach, heavy vehicles as a group will pay their way over time, … However, network averaging itself has created cross-subsidies between heavy vehicles accessing different parts of the network." [p. 4.11]
>
> For instance "… all vehicle classes except B-doubles and road trains cover their attributed and allocated costs. As a class, B-doubles pay about $52 million a year less than their attributed costs, equivalent to under-recovery of about $7000 a year per vehicle." [p. 4.33]

#### *The Authority's View*

The Authority's view is that the Report does not adopt a clear position on both the extent and impact of cross subsidisation within and between road and rail freight infrastructure. At different places in the Report apparently contradictory statements are made such as the following.

> "The under-recovery from B-doubles is financed through higher charges levied on other classes of truck. Further, this under-recovery has implications for competitive neutrality as it applies to those trucks competing most directly with rail." [p. 4.35]

However, the Report also states that the evidence for cross subsidy is not strong.

> "In the Commission's view, the evidence that heavy vehicles competing with rail freight on major corridors are relatively subsidised is not compelling." [p. xxxvi]

The Report also highlights the fact that the Commission's estimates of cross-price elasticities of demand between road and rail freight are low so that increasing the price of freight hauled in B-doubles would not have a large impact on the demand for rail freight. Again the report is effectively diminishing the impact of the effect of road pricing in rail freight usage. However, by the Commission's own admission in the Report these estimates are based on aggregate data and are not differentiated by location and yet it is likely that cross price elasticity of demand will vary markedly by location.

While there may be competitive neutrality in aggregate, rail access charges are calculated by rail route and not on the basis of a rail network as a whole.

In regional areas in WA, rail access charges for grain are set to be competitive with road so that WNR only covers marginal costs with little contribution to capital. On this basis, there is no incentive for WNR to invest in the grain rail network. This could lead to a decline in the standard of the rail track over the longer term which may result in pressure for government investment in the grain network to keep lines open and to maintain operating standards.

If road charges in regional areas were not distorted and cross subsidies removed, then this would result in higher charges for road users in regional areas. In turn, given that rail freight is priced to match road freight for the grain rail lines in WA, WNR could charge higher access charges and include a contribution to capital costs. The ability, under such circumstances, for WNR to achieve a more reasonable return from the grain rail network would be likely to lead to increased investment in this network by WNR and consequently less need for government to consider investing in the grain rail network.

The Authority would not be comfortable with any implication that the intra-modal cross subsidy on road freight (namely B-doubles) is negated by either or both the cost recovery of road freight in aggregate or the potential subsidy of some rail freight networks in other Australian jurisdictions.

Potentially this cross subsidy could have a significant impact on the competitiveness of rail versus road for grain haulage and/or on the long term sustainability of the rail network. If rail owners do not match the artificially low charge for road haulage they will lose tonnage to road. This would be suboptimal from society's point of view as there would be an over use of road and associated under use of rail. However, if the rail owners do match the road haulage charge in order to maintain tonnage then the revenue generated will not be sufficient to contribute to capital. This will result in a deterioration of the rail network.

## Ability to price discriminate and efficiency

### *Report Findings*

The Report suggests that potential efficiency gains can result from the application of Ramsey Pricing as an economically efficient method to allocate common costs across users. This involves charging a higher price to the segments of the market that value the service the most (i.e. are willing to bear the higher costs) manifested in a lower price elasticity of demand. [pp. 5.11-5.13]

The Report suggests that regulators do not accept this principle and suggests that Part IIIA of the Trade Practices Act facilitates increased efficiency by explicitly allowing multi-part pricing and pricing based on demand elasticities.

> Draft Finding 5.3 "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 Commission seeks comments from participants on approaches to achieving an efficient allocation of the common costs of providing rail infrastructure." [p. 5.12]

The Report states that "…pricing may be constrained more generally to the extent that regulators place limits on the ability of rail infrastructure providers to price discriminate between customers, which could generate greater revenue within price bounds." [p. 5.16]

If regulation prevents price discrimination this can result in less economic efficiency. The Report mentions that Ramsey pricing (price discrimination) can be used to capture marginal sales (ie using price discrimination for usage charges and not just common costs). The Report states that this form of pricing may be discouraged or even curtailed by regulators. [pp. 8.9–8.13]

### *The Authority's View*

The ability to price discriminate and whether regulators permit this to occur depends on the legislative provisions in the respective state based rail access regimes.

As noted previously the WA Regime does allow for price discrimination, i.e. pricing based on different demand elasticities, within floor and ceiling prices determined by the Authority.

In some regimes, regulators set reference prices for a particular standard of freight transport service.

In WA, as indicated earlier, the Code permits price discrimination between track users and WNR as the Authority does not set reference prices. The two parties are free to negotiate appropriate access charges on a commercial basis within the floor and ceiling price band determined by the Authority.

## Use of two part tariffs

### *Report Findings*

The Report states that "… rail infrastructure providers in … Western Australia publish reference tariffs in the form of a two-part charge, …" [p. 5.14]

### *The Authority's View*

This statement is incorrect on two counts. First, the Regime in WA does not use a system of reference tariffs and second, rail tariffs in WA are not published in the form of a two part tariff. The structure of access charges is determined on a case by case basis between the negotiating parties with some access charges structured on a two part tariff and others reflecting a single tariff structure. These charges are confidential to the negotiating parties and are not published.

## Government financial contributions to rail freight infrastructure

### *Report Findings*

The Report implies that sizable government financial contributions exist right through all rail networks albeit the most significant contributions have been to ARTC for the interstate network and for construction of the Tarcoola to Darwin railway.

> Draft Finding 5.6 "Direct government subsidies to rail are common and have been sizeable." [p. 5.22]

### *The Authority's View*

In WA the only ongoing government financial contribution to WNR is towards signalling protection equipment at level crossings in some rail routes for safety purposes.

## Vertical separation and the potential for vertical re-integration

### *Report Findings*

The report suggests that where the scope for competition in the above rail operator sector is limited and where there is inter-modal competition (so that the infrastructure owner's market power is limited) it may be the case that the costs of vertical segregation outweigh the benefits. [pp. 10.10-10.13]

> Draft Finding 10.2 "There appear to be no benefits, and some costs, in maintaining or implementing vertical separation on regional rail networks where infrastructure providers are unable to exert market power." [p. 10.13]

### *The Authority's View*

The rail freight industry comprises a combination of government and privately owned businesses.

Most rail freight businesses in Australia are vertically integrated rail companies, such as Queensland Rail in Queensland, Pacific National in Victoria, Australian Southern Railway in South Australia and, until mid 2006, the Australian Railroad Group (**ARG**) in Western Australia.

In a commercial transaction, the owners of ARG in WA sold the above rail and below rail businesses to separate owners. It should be noted that this was not a requirement of government legislation but the result of a commercial transaction.

Vertically separate rail businesses exist in the interstate rail freight market with the track owned by ARTC and the above rail business operated by Pacific National which is a private organisation.

While there may be some merit in vertical re-integration in some rail freight markets to improve efficiencies and reduce costs this may not be practical due to the presence of privately owned businesses with their own objectives which may conflict with the requirement to re-integrate.

This appears to be recognised in the Report by the statement on page 11.5 "Vertical reintegration would require prior privatisation of below-rail operations, however, to preclude reversion to full government provision of rail freight transport."

In the case of WA the government is unlikely to be in a position to consider this issue until the expiry of the current 50 year lease of the rail network to WNR. If sufficient benefits from vertical integration accrue to the parties involved then presumably this would be the outcome of a commercial decision. However, this would not necessarily be in the interests of the overall community.

The questions that need to be considered are: What is the specific economic benefit from vertical reintegration of the State and Commonwealth rail systems? What is the potential for reintegration where there is a perceived net benefit and what would it cost?

## Revocation of access regulation

### *Report Findings*

The Report states that "… the potential market power of many below-rail operators is effectively constrained by competition from road or coastal shipping. Therefore, the administrative costs and potential distortions arising from access regulation are likely to

outweigh the benefits that would otherwise flow from additional competition … strong case for moderating or even revoking some access regimes … continued price regulation may only be required on coal lines in NSW and Queensland where operators are more likely to have significant market power …" [p. 11.4]

### *Report Draft recommendation 11.4*

> "There appears to be scope to moderate or even revoke access regulation where pricing by vertically-separated below-rail operators is significantly constrained by competition from road and sea freight transport operators. Building on COAG's agreement to promote nationally consistent access regulation of major infrastructure, a process should be established for reviewing the need for access regulation of vertically-separated rail networks." [p. 11.4]

### *The Authority's View*

The Report seems to have omitted the significant bulk commodity haulage in WA. As indicated earlier, bulk commodities haulage under the regime in WA represents approximately 80% of the State's annual total haulage task under the Regime. Furthermore, the share of bulk haulage component is expected to increase significantly within the next three to five years with iron ore and alumina producers announcing significant increases in expansion in the output of these commodities. These additional tonnages are likely to increase the total haulage of bulk commodities under the Regime to 50-60 Mta from 30-40 Mta currently.

The Report also states that "Overall, regulatory and governance reform of rail freight transport has the potential to bring significant productivity benefits as well as an improved investment capability". [p. 11.4].

The Authority considers that the potential for productivity benefits is a generalisation which is unlikely to apply in the case of the WA regulated rail network. This is because the WA Regime is based on a light handed regulatory approach where rail users have the ability to negotiate access prices with WNR within the floor and ceiling limits determined by the Authority.

## Inconsistent State-based regulation

### *Report Findings*

The Report notes that various submissions stated that the inconsistency of regulations between jurisdictions adds to compliance costs and has a negative impact on rail efficiency. This includes safety and environmental regulation as well as access regulation.

The possibility of a harmonised or centralised system for economic regulation of rail is raised.

> Draft Finding 10.4 "There is considerable scope for greater national consistency and coordination in rail access regimes, pricing and other regulatory frameworks – including operational practices and technical standards."

### *The Authority's View*

In 2005, the Authority undertook a review of the Code and found that the WA Regime was largely consistent with the ARTC Undertaking except for the following:

- The WA Regime uses Gross Replacement Value as asset value methodology whereas the ARTC Undertaking uses Depreciated Optimised Replacement Cost.
- The WA Regime does not require the setting of reference tariffs whereas the ARTC Undertaking has a requirement for reference tariffs.

- There are minor differences in the suite of Key Performance Indicators required to be reported by rail track owners.

The WA Regime allows for an ARTC Wholesale Access Agreement where train operators can negotiate with ARTC such that the terms and conditions negotiated would also apply on WNR's network from Kalgoorlie to Perth. This provides for a seamless operation between interstate rail networks which meets the requirement as outlined in the Report's Draft Finding 10.4.

To date Pacific National the major interstate train operator has chosen not to use the ARTC Wholesale Access Agreement but to negotiate directly with WNR an access agreement for the Kalgoorlie to Perth rail line.

## Summary

The Authority's view is that the Commission may wish to consider investing resources into collecting disaggregated data in order to carry out analysis at the regional level. This would enhance the analysis, findings and recommendations in the Report.

If this is not feasible in the available time, then the Authority suggests that the Commission should consider modifying the draft findings and associated draft recommendations based on analysis of aggregate data to reflect the circumstances which apply at the regional level. This is particularly true for the analyses and findings about cost recovery of road freight in aggregate and the implications for competitive neutrality between types of road trucks (such as B-doubles) and rail for grain haulage

If the competitive neutrality issue at the regional level is not addressed there is unlikely to be an improvement in the competitive position of rail vis-a-vis road in regional haulage tasks.