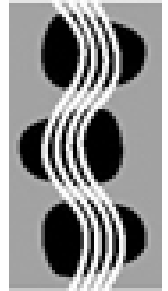


NSW MINERALS COUNCIL



**SUBMISSION TO
THE PRODUCTIVITY COMMISSION:**

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

October 2006

SUMMARY

The NSW Minerals Council (“**NSWMC**”) welcomes the key point in the Discussion Draft Report on the Productivity Commission’s Review of Road and Rail Freight Infrastructure Pricing (“**Discussion Draft**”) that efficiency in each of the road and rail transport modes would be promoted by regulatory reforms to reduce costs and by improved investment decision-making processes.

This submission proposes regulatory reforms which the NSWMC believes will contribute to improvements in efficiency and in investment decision-making processes. The NSWMC’s comments cover mainly the following issues

Encouragement of investment in regulated infrastructure

The NSWMC proposes that regulated rates of return include an explicit investment incentive component, and that there be a mechanism to oblige infrastructure owners to proceed with required investment once the investment incentive component is determined.

Vertical reintegration of parts of the rail network that compete directly with road

Restoration of vertical integration of any part of the NSW rail network used for coal transport would reduce competition for rail freight of coal. Also, lines which may not currently be regarded as ‘major regional coal lines’ could become major coal lines in the future and require vertical separation once again if vertically reintegrated now.

National consistency and coordination in rail access regimes

- With the adoption of proposed separate ARTC access undertakings to the ACC for the interstate rail network in NSW and the Hunter rail network, there will be several possible combinations of the NSW Rail Access Undertaking, the ARTC interstate Access Undertaking and the Hunter Access Undertaking applying to coal transport in the Hunter region which will present issues of consistency between access regimes. A single access regime applying to all coal freight, or uniformity between regimes in treatment of coal traffic, would reduce the scope for confusion and lack of uniformity in access arrangements for coal hauls.

Discriminatory pricing and non-price discrimination

Monopoly service providers who apply discriminatory pricing should be required to justify that discrimination on the grounds of economic efficiency.

Priority to access and flexibility in allocation of trainpaths

Current legislated priority for passenger trains and *de facto* priority for timetabled freight services, which pay minimum access charges while coal traffic on the Hunter constrained network pays maximum access charges for lowest priority, detract from economic efficiency and negate the claimed purpose of discriminatory pricing.

ENCOURAGEMENT OF INVESTMENT IN REGULATED INFRASTRUCTURE

The Discussion Draft refers in several places to the problem of monopoly regulation and investment

- There currently is potential for access regulation to discourage investment in rail infrastructure (Key points, p10.1)
- The recent adoption of the recommendations from the Productivity Commission’s 2001 National Access Regime report, particularly relating to the inclusion of an objects clause and pricing principles, is likely to reduce the potential for access regulation to discourage investment. (Draft finding 10.8)
- Box 10.4 outlines some of the proposals of the Commission in its 2001 Review of the Trade Practices Act. It includes proposals for encouraging investment, many of which

have been adopted in the *Trade Practices Amendment (National Access Regime) Act 2006*.

Investment, or lack of it, in regulated infrastructure has been a major weakness in National Competition Policy. This was acknowledged by the Commission in its Report No. 17 of 2001 on its Review of the National Access Regime and has been evident in recent years in a lack of adequate capacity of key infrastructure for parts of the Australian coal export industry.

The Trade Practices Amendment (National Access Regime) Act 2006 has been enacted to try to deal with this weakness. S44ZZCA has been incorporated in the *Trade Practices Act (Cth) 1974* (“Act”). This provides, in part, that uniform pricing principles be included in all access regimes and that

The pricing principles relating to the price of access to a service are:

- (a) that regulated access prices should:
 - (i) be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services; and
 - (ii) include a return on investment commensurate with the regulatory and commercial risks involved; and

This introduces a new component to the Act, which could be interpreted as providing an open-ended rate of return on investment. The NSWMC recognises that monopoly service providers are entitled to earn a return on investment commensurate with the regulatory and commercial risks involved and is prepared to meet that cost.

As Box 10.4 of the Discussion Draft says, the Commission proposed modifications of Part IIIA of the Act to lessen the risk of access regulation deterring investment in essential infrastructure. Among the modifications proposed is a provision specifically recognising discriminatory pricing where this aids efficiency. Discriminatory pricing has been a feature of the NSW Rail Access Undertaking since it was established in 1996. Yet this undertaking appears to have been no more successful in encouraging investment than other access regimes that do not apply discriminatory pricing. In all cases the key factor driving investment appears to be perceived risk and the rate of return to the service provider.

As pointed out in the NSWMC’s submission in May, some access regimes and undertakings already appear to have an investment premium incorporated in them. Recent determinations by the Queensland Competition Authority (“QCA”) for the Dalrymple Bay Coal Terminal (“DBCT”) and by the Independent Pricing and Regulatory Tribunal of New South Wales (“IPART”) for the NSW Rail Access Undertaking appear to reflect a premium for investment. In the case of the NSW Rail Access Undertaking, when IPART first set the rate of return in 1999 it nominated a value that was close to the top of the plausible range it had identified and about 1.0% above the midpoint of the range. When IPART reviewed the rate of return in 2005 it again nominated a value near the top of the realistic range, in order to encourage investment. In both that case and the DBCT case, the infrastructure owners had publicly stated their views on a value of rate of return that they considered necessary to induce them to invest and the rates recommended by the respective regulators were close to those values.

The NSWMC suggests that, if it is determined that the customary method of setting rates of return results in rates of return that are genuinely too low, regulators should include a separately identified “investment encouragement component” in the regulated rate of return. This would be added to the value determined by calculation using the regulator’s best estimate of the various parameters involved. This would replace the current practice of identifying a range for the various input parameters and then selecting the regulatory rate of return from within the resulting range of rate of return, with little or no explanation of how the variation from the mid-point of the range is quantified. Expressing the rate of return in this way would clarify the existence and magnitude of the investment encouragement component.

Determination of the magnitude of the rate of return needs to involve users as well as the infrastructure owner and regulator. Ideally, users and the infrastructure owner would be able to negotiate a mutually acceptable value. In practice however there is an asymmetry of power between

monopoly infrastructure owner and user. If there were not, there would be no need for regulation and regulators.

The NSWMC submits that the regulatory process needs to provide a mechanism to secure the commitment of infrastructure owners that once the rate of return incorporating an investment incentive component is set, they cannot refuse to undertake an investment on the grounds, stated or implied, that the rate of return is currently or may be set too low.

RESTORATION OF VERTICAL INTEGRATION OF PARTS OF THE RAIL NETWORK

There are several references in the Discussion Draft to restoring vertical integration to rail networks where infrastructure providers are unable to exert market power.

- 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. (Draft finding 10.2)

The Commission seeks further evidence from participants regarding the impacts of vertical separation or integration on the interstate track and on the major regional coal lines (p10.13)

- In view of the lack of market power of vertically separated below-rail operators competing with road freight, there is likely to be a strong case for price regulation only for coal lines in New South Wales and Queensland and for those parts of the network where below-rail operators also run above-rail services. (Draft finding 10.7)
- Given the mixed success of vertical separation in encouraging above-rail competition, whether allowing vertical reintegration of particular rail lines or networks would promote their commercial viability should be subject to detailed independent examination. (Draft Recommendation 11.5)

The Commission seeks the views of participants about the potential costs and benefits of reintegration on specific rail networks.

Draft finding 10.7 contains a potential Catch-22. If non-coal rail networks are vertically re-integrated in order to avoid price regulation, they will by definition have below-rail operators also running above-rail services, and hence require price regulation.

The NSW coal industry has benefited enormously from the introduction of National Competition Policy and vertical separation of rail networks in NSW. Monopoly rent of around \$75M per year for rail access has been eliminated and haulage rates have decreased. Australia's two largest rail haulage operators are currently engaged in haulage operations on the Hunter rail network. The efficiency of rail operations has also improved markedly in recent years.

The reintegration of networks that are currently vertically separated has potential problems for coal traffic. The movement of coal in NSW may be considered in three distinct categories

1. coal hauled entirely on the Hunter 'constrained network' (where access charge for a coal haul cannot be increased without decreasing access charge for other haul, as determined by the ceiling test in the NSW Rail Access Undertaking)
2. coal hauled partly on the constrained network
3. coal hauled entirely off the constrained network

While most coal hauled by rail in NSW is in the first category, there is significant movement of coal on lines where a price increase in access charge for coal haulage without a corresponding decrease on another coal haul would not cause a breach of the ceiling test. But, unlike most non-coal rail traffic, rail freight of coal traffic on these lines is not competitive with road freight. This is because either development consents or mining leases mandate rail freight, or road freight is uncompetitive with rail freight, or both.

Consequently, if vertical integration were to be reinstated on lines in the second and third categories, it would remove two competitive elements

- competition between freight haulage operators who have access to the network on an equal basis
- consistency of access charges to coal traffic
 - with a single infrastructure owner, the infrastructure owner is in a much better position to apply consistent charges to coal traffic across all types of networks
 - with different infrastructure owners on the vertically integrated and vertically separated parts of the network, there is a risk that the basis for access pricing will differ between infrastructure owners and upset the competitive balance between coal producers in their respective end markets.

While there may be a case for minor branch lines to operate as vertically integrated entities, none of the tracks currently carrying significant quantities of coal (say over 500ktpa) falls within this category.

This issue is also relevant to the following discussion on national consistency and coordination in rail access regimes.

NATIONAL CONSISTENCY AND COORDINATION IN RAIL ACCESS REGIMES

The Discussion Draft makes several references to consistency and coordination in rail access regimes

- There is considerable scope for greater national consistency and coordination in rail access regimes, pricing and other regulatory frameworks – including in operational practices and technical standards. (Draft finding 10.4)
- There are significant potential economic benefits from achieving a nationally consistent approach to access regulation of the rail sector. The reform measures agreed by COAG in February 2006 represent a way forward to achieving such consistency. Progress of the current agreed COAG reforms should be monitored to determine whether there are likely to be additional net benefits from moving to a single national regulator or regulatory regime. (Draft finding 10.6)

The Commission seeks comments from participants on the desirability of moving to a single national regulator or regulatory regime for rail infrastructure.

The Commission seeks comments from participants regarding the appropriateness of the current coverage of access regimes for rail infrastructure. What might be the effects of removing access regulation on the vertically separated elements of the interstate track? (p10.23)

- Progress in implementing the February 2006 COAG agreement to adopt a nationally-consistent approach to regulation of all nationally significant infrastructure, should be monitored in relation to rail to determine whether there are likely to be additional benefits in moving to a single national regulatory regime and regulator. (Draft Recommendation 11.3)

The lease to ARTC of the interstate and Hunter rail networks in NSW and the management by ARTC of country branch lines has simplified access issues on the interstate rail network, but could greatly complicate access for some coal traffic. Access on the NSW rail network is currently governed by the NSW Rail Access Undertaking. ARTC inherited this undertaking from Rail Infrastructure Corporation. It is not an undertaking in the sense of that word in Part IIIA of the Act. Rather it is an access regime, an earlier version of which was certified in November 1999 as being effective (as that word is defined in the Act). Certification lapsed in December 2000 and has not been renewed.

When ARTC entered into the lease and management arrangements in NSW it indicated it would submit an access undertaking to the ACCC for the track it leased, while track it does not lease would continue to be subject to the NSW Rail Access Undertaking, which is under the control of the NSW Government. ARTC has not yet submitted an undertaking to the ACCC for its NSW track.

ARTC has indicated that it will submit separate undertakings for the interstate rail network and the Hunter rail network. This is a logical and reasonable step. When these separate undertakings are in force however coal traffic could be subject to several different regimes, sometimes applying to the same haul. Possible combinations of access regimes applying to coal traffic would include

- traffic that is restricted to the Hunter constrained network will be subject only to the ARTC Hunter undertaking
- traffic from the Gunnedah region could be subject to the ARTC Hunter undertaking, the ARTC interstate undertaking and the RailCorp NSW Rail Access Undertaking
- traffic from the Southern Coalfields to Port Kembla could be subject to the ARTC interstate undertaking and the RailCorp NSW Rail Access Undertaking

These combinations of access regimes will present issues of consistency to rival or surpass those on the interstate network that ARTC's NSW lease resolved. It would be desirable for the same access regime to apply to all coal traffic, so that access for coal can be treated consistently. Alternatively, a mechanism is required to ensure that the separate regimes treat coal in a consistent way. Otherwise, the current competitive balance between coal from different regions, served by different parts of the rail network, could be destabilised.

DISCRIMINATORY PRICING AND NON-PRICE DISCRIMINATION

The Discussion Draft has the following references to price discrimination and efficient pricing

- Prices set to recover each mode's total costs, which accord as closely as possible to Ramsey principles, have the potential to promote efficient use of road and rail freight infrastructure, while meeting a self-financing requirement. (Draft Finding 8.4).

While efficient, such pricing may be regarded as inequitable, however, because those users with few alternatives ... may be required to pay more. Moreover, given the information requirements and other hurdles, in practice, Ramsey pricing at best is likely to be applied in a 'rough and ready' manner. Nonetheless, even this is likely to be superior (in terms of efficiency) to other allocation methods. (p8.11)

- The objects clause, declaration thresholds and pricing principles (which, among other things, allow for multi-part pricing and price discrimination when they aid efficiency) now embodied in Part IIIA of the Trade Practices Act should be incorporated in all rail access regimes. (Draft Recommendation 11.3)

The NSWMC commissioned research in the mid-1990s by ACIL Economics and Policy (now ACIL Tasman) on Ramsey pricing of rail access as applied to the Hunter rail network. ACIL found that Ramsey pricing, if perfectly applied, would provide a small benefit to economic efficiency compared to Activity Based Costing. But Ramsey pricing, if imperfectly applied, had the potential to result in a large detriment to economic efficiency.

As the Discussion Draft acknowledges, Ramsey pricing at best is likely to be applied in a 'rough and ready' manner. Nevertheless it recommends that pricing principles (that permit multi-part pricing and price discrimination when they aid efficiency) now embodied in Part IIIA of the Trade Practices Act should be incorporated in all rail access regimes.

The NSW Rail Access Undertaking has permitted price discrimination since 1996. It does not, however, require that the infrastructure owner demonstrate that discrimination it applies does indeed increase efficiency. If discrimination is applied, the infrastructure owner should be required to demonstrate to the user discriminated against, and the regulator if requested by a user, that the discrimination does enhance efficiency.

- Greater flexibility in the allocation of train paths has the potential to promote greater efficiency. Auctioning potentially has significant benefits but may not be cost effective. Development of cost effective mechanisms designed to reveal valuations placed on train paths by users is to be encouraged (Draft finding 10.3)

The draft finding justifiably hints that the legislated priority on passenger train services provided under the Transport Administration Act 1984 (NSW), the NSW Rail Access Undertaking and other rail access regimes in Australia leads to economic inefficiency. As has been pointed out in previous submissions by the NSWMC to the Commission, current practice is the opposite of the Draft finding. Whatever the value of a trainpath, reserving it for any particular traffic that pays the lowest possible access charge results in a loss of economic efficiency (unless the reserved trainpaths happen to be unwanted by all other traffic). The same argument applies to any traffic which pays the lowest possible access charge without legislative requirement, such as timetabled freight services, is given priority over traffic that pays the highest possible access charges. Quality of service should match the access charge paid.

Draft finding 10.3 of the Discussion Draft is

- Greater flexibility in the allocation of train paths has the potential to promote greater efficiency. Auctioning potentially has significant benefits but may not be cost effective. Development of cost effective mechanisms designed to reveal valuations placed on train paths by users is to be encouraged

This draft finding hints at how inefficient is the legislated priority on passenger train services provided under the Transport Administration Act 1984 (NSW), the NSW Rail Access Undertaking and other rail access regimes in Australia. As has been pointed out in previous submissions by the NSWMC to the Commission, current practice is the opposite of the Draft finding. Reserving a trainpath for a particular traffic that pays the lowest possible access charge regardless of the value of that trainpath results in a loss of economic efficiency unless the reserved trainpaths happen to be unwanted by all other traffic. The same argument applies to any traffic which pays the lowest possible access charge without legislative requirement, such as timetabled freight services, is given priority over traffic that pays the highest possible access charges. Quality of service should be directly, not inversely, related to the access charge paid.

OTHER MATTERS

Land valuation

- Opportunity cost is the most appropriate value for valuing land upon which road and rail networks are built.

Opportunity cost is the appropriate approach to land valuation from an economic efficiency perspective. For road and rail networks as a whole, the opportunity cost of land is its value in the next best alternative use, without benefits conferred by access to transport networks. For incremental road and rail projects, the appropriate land value is its market value without the project. (Draft Finding 8.7)

The NSW Rail Access Undertaking provides that land upon which the rail network is built be valued at zero. For a network as old as the Hunter rail network (100 – 150 years), the NSWMC considers this is an appropriate basis for valuation.

Regulatory restrictions on freight movement

- ***The Commission seeks information from participants identifying any remaining regulatory restrictions on freight movement. In particular, are there any remaining regulations that effectively restrict particular commodities to rail or to road?***
(p10.31)

Transport of coal in NSW is, with a few exceptions, restricted to rail by conditions of development consents or mining leases. These conditions were imposed in many cases when high monopoly rents were being imposed on rail freight of coal. At the time road transport would have been competitive with rail for many mines to which the restrictions applied. Since the removal of monopoly rent and introduction of competition in rail haulage rail freight is now a low-cost and efficient means of transport for most coal mines.

Another restriction on coal transport has an adverse effect on costs and efficiency. Coal transport to Port Kembla is restricted to specific times. This was discussed in the NSWMC's submission in May to the Issues Paper.