

SUBMISSION TO PRODUCTIVITY COMMISSION REGARDING DRAFT REPORT ON ROAD & RAIL FREIGHT INFRASTRUCTURE PRICING

1 EXECUTIVE SUMMARY

Pacific National welcomes the opportunity to comment upon the substantial Productivity Commission draft report "Road and Rail Freight Infrastructure Pricing" published in September 2006.

The conclusion to be drawn from the draft report is that, with the exception of minerals hauls, investment in road is economically more efficient than investment in rail and governments should therefore not invest in rail. The inevitable result of that course of action would be a continued decline of rail as the rail infrastructure wears out and service levels decline to the point that rail disappears except for the minerals hauls. This is already occurring on some grain branch-lines. The logical extension of this thinking is that the existing rail corridors should be paved over and turned into dedicated road freight corridors as this is the economically efficient course of action.

The Commission's Key Findings

In its draft report, the Commission has concluded two key points:

- 1) Road freight covers the full economic costs of its infrastructure and rail does not except for heavy minerals hauls.
- 2) Raising road charges will have negligible effect on modal share and hence road infrastructure charges do not impact on competitive neutrality.

It is recognised that the Commission has been tasked to provide a report to COAG within an unrealistic time-frame and that this has led to what must be described as a partial analysis of an extremely complex area. However, it would be irresponsible for the Commission to draw far-reaching conclusions on the basis of an incomplete, and in Pacific National's view flawed, assessment of the issues.

Pacific National disagrees with the Commission's conclusions for the following reasons:

- 1) The comparison of the costs of road and rail infrastructure is flawed because the basis of the comparison is fundamentally inconsistent. Road freight is evaluated on the basis that it covers its marginal costs plus makes a small contribution to common costs while rail is evaluated against the full economic costs of providing the infrastructure on a stand alone basis. The true fact is that both road and rail freight, with some exceptions in both cases, cover their marginal costs and make some contribution to fixed costs.
- 2) The analysis of the costs that road freight bears is substantially distorted by a failure to recognise the costs that would be borne by road in the absence of rail or a reduction in rail volumes.
- 3) The allocation of common costs to road freight vehicles on the basis of Ramsey pricing as argued by the Commission is internally inconsistent. If modal share is so unamenable to variation through pricing changes, as demonstrated by the Commission's modal share modelling, a correct application of Ramsey pricing would lead to road freight carrying a far greater share of common costs.
- 4) The Commission's assessment that a third of road costs are in fact non-allocable is fundamentally different to the treatment of infrastructure costs in the rail sector. The exclusion of a substantial proportion of these costs is disputed by a number of parties participating in the inquiry and the Commission has not mounted a compelling case that these exclusions are justified. Further, the draft takes no account of the Federal and State contributions to local government for the development and maintenance of the

local road network, instead suggesting that the local road network is fully funded by developer contributions and local government rates.

- 5) The elasticity modelling which is fundamental to the Commission's conclusions is inconsistent with the publicly demonstrated angst of truck operators when road user charges are raised eg blockades of public roads and substantial political campaigns, and therefore must be seriously called into question. Further, the analysis takes no account of the impact of raising rail service levels to a point where rail is seriously able to compete for the majority of road freight. If the service paradigm is fundamentally altered, it is likely that the sensitivity of modal share to price will rise significantly. It is the stated aim of the Australian Transport Council to put rail into such a position and is the focus of the current investment by ARTC in the interstate rail network. Thus the basic conclusion of the Commission is grounded on a false assumption that the existing service/price relationships between road and rail are in a steady state and therefore predictive of future market behaviours.

While the draft report recognises the issue of Greenhouse gas emissions it fails to recognise that there are significantly lower emissions arising from the use of rail for the freight task, suggesting instead that it is up to Government to put in place a "whole of economy" solution. This is another demonstration of the failure of the report to recognise a significant benefit brought to the community by the use of rail as compared to road. Ignoring such benefits further supports the erroneous conclusions that there are no competitive neutrality issues between road and rail and the latter is an economically inferior transport mode.

Pacific National believes the conclusions that must flow from the report's technical analysis are at odds with the reality that rail freight is an essential part of Australia's future. Governments around Australia have identified that road cannot cope with the forecast growth in the transport task without a significant contribution from rail. Indeed, the loss of rail modal share would have massive cost implications, including congestion costs, for road. It is most unfortunate that the draft report has not included a consideration of the costs of providing a road network that will fulfil the projected demand, however it is noted that Commission does flag that road freight will very soon not be covering even the distorted allocation of costs that it is currently asked to bear.

If governments wish a healthy rail freight industry, and there are very good economic, social and political reasons why this would be the case, there will need to be substantial investments in rail infrastructure to deliver the service capabilities required to compete with road.

A Way Forward

If the answer is not a simple reordering of road user charges, and it is not appropriate to divest the country of its non-bulk rail freight capability, then what is the solution? The problem for both road and rail is how to provide an appropriate level of funding such that the infrastructure required to service projected demand is provided.

Pacific National suggests that an appropriate model exists in the Swedish approach. This approach is based on:

- A commitment by government to fund both road and rail infrastructure.
- Pricing of infrastructure access for both modes at marginal cost.
- Evaluation of investment programs for both modes on consistent criteria through a central agency.

As this model bases infrastructure pricing to users on a marginal cost basis, it provides appropriate pricing signals between modes. In turn, combined with an appropriate service capability for both modes this ought to lead to efficient modal choices by freight transport consumers.

Rail Regulation

The Commission has raised a number of issues regarding rail regulation in Australia. Pacific National has responded in some detail to these issues in this submission and our position is summarised below:

- Pacific National strongly opposes the removal of rail regulation while vertical separation remains. Rail regulation covers a much wider area than price regulation and sets the parameters for the entire relationship between the monopoly track owner and the rail operator. The mere fact that prices are constrained by an alternative mode does not serve to safeguard the train operator from the infrastructure owner's monopoly position nor does it guarantee that the track owner will behave for the benefit of the rail system as a whole.
- If vertical and horizontal separation are to be retained then regulation must play its part in minimising the costs of separation through obligating behaviours that would otherwise be discretionary over areas such as investment and coordination.
- Pacific National believes that the existing allocation of common costs in rail infrastructure charges is appropriate and there is no distortion introduced by current access price structures.
- Vertical separation does have significant impacts on the efficiency of rail at both the investment and operational level. Further inefficiency arises through the horizontal separation of the network between different infrastructure owners. This is a matter not specifically considered by the Commission but which has a considerable impact on train operations and the efficiency of rail.
- A single national rail regulator may be beneficial so long as the current regulations are not adopted without improvement and the regulator recognises that different arrangements may need to be made for different traffics eg coal compared to grain and intermodal.

2 BACKGROUND

The Productivity Commission produced a draft report into "Road and Rail Freight Infrastructure Pricing" in September 2006 as part of an investigation in response to terms of reference from the Commonwealth Treasurer.

The terms of reference require the Commission to investigate:

- the full economic, social and environmental costs of land based freight,
- whether pricing for road and rail freight infrastructure distorts competitive neutrality between the modes,
- what pricing structures ought to apply, and
- whether there are any competition or regulatory constraints on the efficient pricing and operation of road and rail freight.

The Commission is considering these matters and has asked for public submissions to respond to the draft report.

This submission by Pacific National seeks to address a number of the issues and questions raised by the Commission. Owing to the short time available to respond, the submission is necessarily brief and the arguments are not supported by evidence that might otherwise have been provided had more time been available.

3 CURRENT POSITION

The draft report shows that market share of transport between modes is segmented into bulk and non-bulk with rail dominating in bulk and road in non-bulk. The bulk minerals tasks, particularly the movement of coal for export are well suited to rail and road only competes for these movements for short hauls or hauls where it is uneconomical to construct new rail lines.

Other bulk tasks such as grain are more contestable between transport modes, particularly where the cost of direct delivery by road to port or to domestic end-user compare favourably with road movement to regional storage (ie country grain silos) for on-forwarding by rail. Issues such as the availability of suitable storage at the end location and customer cargo assembly requirements play a significant part in determining which mode will be used, as well as the total cost. This illustrates one of the difficulties in attempting to evaluate infrastructure access pricing using a relatively narrow economic view as such an analysis will fail to recognise these other factors in determining modal choice.

The focus of the road – rail debate is on the non-bulk segment of the market, particularly the inter-capital and regional movements. It is in this segment of the freight market that it is expected that transport modes will compete most vigorously. However, large parts of this market segment may not be effectively contestable under current circumstances. In all cases, rail suffers a significant time penalty compared to road and therefore is not able to compete for time sensitive freight except at the margin. The main competition is for freight that is less time sensitive, where price becomes a more important consideration. At the other end of the scale coastal shipping is an effective competitor for time insensitive freight, being able to operate more cheaply than rail.

A key determinant of rail's ability to compete with road for a larger part of the market is the provision of a quality of service that is acceptable. The principal current service deficiency is the overall transit time from pick-up to delivery. The level of service improvement required is substantial. The Australian Rail Track Corporation (ARTC) has committed to a major investment program for the Melbourne – Brisbane rail corridor with the expectation that this will result in significant reductions in transit times. While these reductions will be most welcome, it will still leave a deficit compared to road due to the additional pick-up and delivery time between the

end customer and the rail terminal. Thus rail will remain at a service quality disadvantage. Table 1 shows the total transit times on the Melbourne – Brisbane corridor for road and rail including the improvements expected once the ARTC investment in the corridor is completed.

TABLE 1: TRANSIT TIMES: DOOR TO DOOR (HOURS)

Corridor	Current Rail	Projected Rail	Current Road
Melbourne – Sydney	21	17.5	11
Sydney – Brisbane	21	19	15
Melbourne – Brisbane	43	35	21 - 24

Source: North-South Rail Corridor: Study ACIL Tasman, Hyder Consulting, Ernst & Young, June 2006

The ARTC investment is predicated on rail achieving high levels of volume growth, approximately doubling market share in a market that is expected to double thus leading to around a four-fold increase in task over time. If rail is required to fund the investment through access charges, then failure to achieve these volumes could lead to a failure in funding, either through inability to sustain higher access charges or through a shortfall in revenues to ARTC and other track providers on that route (RailCorp and QR).

The Commission has noted that rail infrastructure owners are prepared to accept low returns (on a replacement cost based evaluation) for the interstate routes. Above-rail operators are also struggling to make these routes profitable, particularly the North – South routes. The Commission should not assume that rail freight operators on these corridors will continue to operate in an environment where they are not able to attract a viable market share at reasonable profit levels, particularly where they will need to make substantial investments in rollingstock and other assets to meet the projected task. It is possible that rail operators will abandon the North – South route altogether if the long term prospects for profitability do not substantially improve or alternatively adopt strategies to maximise returns from the existing fleet while avoiding unprofitable new investment. The draft report does nothing to alleviate this concern, instead it appears to be promoting the view that road is the economically more efficient mode and therefore support for rail should be abandoned.

4 PRODUCTIVITY COMMISSION ANALYSIS

4.1 PAYGO ANALYSIS

The draft report reviews the PAYGO system in some detail. Pacific National is of view that the overall conclusion of the report that road freight is paying its way is based on a flawed analysis. A number of the key assumptions underpinning the Commission's assessment are unwarranted and some of the methodology of the analysis is inappropriate.

Excluded Costs

Approximately one third of the PAYGO expenditure is excluded from consideration at all. As noted in several submissions, that the justification for this level of exclusion is far from compelling and is a substantially different treatment to the rail assessment. The quantum of the exclusion, and the level of coverage of allocated road costs is so fine that even a modest additional allocation from this pool of expenditure would invalidate the Commission's position that road freight pay its own way. In responding to the draft report we note the following specifically related to these exclusions:

- The draft report takes no account of the Federal and State contributions to local government for the development and maintenance of the local road network, instead the draft report suggests that the local road network is fully funded by developer contributions and local government rates. By ignoring government contributions, the

analysis justifies the exclusion and therefore understates that quantum of costs allocable to road freight.

- The draft report also dismisses the impact of freight vehicles on local roads on the grounds that these roads are mainly for access to homes and businesses. However, it is far from clear that freight vehicles do not make substantial use of local roads to access those businesses and therefore the logic of excluding all of those costs is further compromised.
- A proportion of the expenditure is associated with major road “amenity” rather than urban and local roads. Notwithstanding any view about the exclusion of local roads, the exclusion of significant expenditure on major roads has not been justified by the Commission whether it is associated with “amenity” or otherwise. In contrast, evaluations of rail expenditure typically include all such costs whether strictly related to the needs of the system or not (eg the fencing of rail corridors, inclusion of noise barriers).
- The draft report argues that the exclusion of interest costs is justified because that is merely a financing decision is curious. It is clear that revenues are received from road users over time (eg as fuel is purchased, excise revenues are collected) and therefore there will inevitably be a timing differential between expenditure on roads and receipt of revenues. As any small business knows, the cost of working capital is anything but free. The exclusion of financing costs could only be justified if it could be shown that revenues are received at the time of, or prior to, expenditure and the draft report shows no evidence that this is the case.
- Notwithstanding the NERA paper in the Australasian Railways Association submission, Pacific National strongly disagrees that revenue from fines should be netted off against law enforcement expenditure. Such a view sees fines as some form of “user pays” which Pacific National argues is inappropriate. Rather Pacific National suggests that a fine is a penalty meted out by Government expressly to deter and punish law breaking; it is not (and should not be seen as) a revenue raising measure. This view is reinforced by the fact that, in some instances, imprisonment is an alternative penalty for breaking some traffic laws. How would one offset that against the enforcement cost? In contrast to the road enforcement approach, rail is required to bear directly the full cost of regulatory enforcement.¹
- It may be that it is erroneous for some of these amounts to be identified as road infrastructure costs eg the costs of administering vehicle registration and driver licensing are not, strictly speaking, road infrastructure costs at all. It might be useful for the Commission to exclude such costs (and related revenues if these are also included) where there is another charging mechanism as their inclusion serves to obscure the debate.

Common Costs

The draft report discusses the allocation of common costs between road users. These costs account for approximately another third of the total costs under the PAYGO system. The draft report recognises that the allocation of these costs is problematic, particularly the difficulties of adopting a Ramsey pricing approach. Putting the difficulties of ascribing different values to different truck types aside, heavy vehicles are allocated 7.6% of the \$3.9b of common costs. Unfortunately, the draft report does not ultimately provide any rationale for the adoption of the current allocation of common costs between passenger and freight vehicles other than it is an application of Ramsey pricing principles. However the report’s conclusion is that road user charges are insignificant in determining modal share. This raises the question as to whether this allocation of common costs is appropriate under Ramsey pricing. One would expect such a

¹ Note that rail enforcement typically does not call on an external police force, instead track providers and train operators are subject to substantial licensing obligations that promote a high degree of self-regulation (eg through internal safety systems, on-going accreditation, audit processes) and, in each jurisdiction, a rail safety regulator that has substantial enforcement powers.

flat demand elasticity would allow for heavy vehicles to absorb a significantly higher proportion of common costs without an effect on market share.

A conclusion that arises from the Commission's view of the allocation of common costs is that it is appropriate for road freight to take advantage of its ability to operate within a relatively densely trafficked passenger network by paying near marginal costs. This may well be a rational economic approach when viewed as a cost allocation problem between road users in isolation (notwithstanding the inconsistency with Ramsey pricing principles) but a consequence for the economy as a whole is likely to be that rail will never be the economic choice over road for the majority of the non-bulk freight task because road freight is able to gain access on a marginal cost basis whereas rail freight is saddled with paying the full cost of the network.

It would be illuminating if the Commission was able to provide an evaluation of the costs of a road freight network on a stand alone basis. It is noted that the interstate rail freight network (with the exception of the entry points to Sydney) is virtually stand alone already and is evaluated by the Commission as such. Unfortunately the Commission has not provided such an evaluation for road and therefore the comparison is no comparison at all.

Opportunity Cost

It is also notable that the analysis misses any interconnection between the effect of the presence of rail on road costs ie the opportunity cost represented by the existing (and future) diversion of freight onto rail. For example, the draft report recognises the conclusions in the Brereton Report that indicate there are considerable congestion costs that would otherwise be borne by road if rail did not exist but the Commission does not appear to have considered these effects in its conclusions. Given the anticipated growth in the transport task, if rail fails to substantially gain market share then it is questionable whether the Commission's methodology for allocation of costs under the PAYGO system could remain unchallenged. That is, there will need to be substantial investments to avoid the road network becoming severely congested, purely from the increased freight task and the draft report does not appear to consider that such costs ought properly to be allocated to road freight rather than be masked behind passenger vehicle demand.

In summary, the draft report indicates that road freight vehicles cover their allocated costs but the allocations are highly questionable as between road users and even more so when considered on a broader economic scale between transport modes.

4.2 RAIL COST ALLOCATION

The Commission noted that, with the exception of the QR network, land and associated earthworks are excluded from consideration in the cost base for rail. Apart from this, all expenditures associated with rail infrastructure are included in the asset base for evaluation under the DORC² method. It should be noted that typically it is past expenditures on land and earthworks that are excluded from the valuation and that any new expenditures on this type of asset would be included in the value. Thus, in comparing rail on an equivalent basis to road under the PAYGO system, land and earthworks expenditures would be included.

It is further noted that the draft report states that 94% of the NSW network is valued at zero. For clarification, this needs to be understood in context. It is correct that the network except for the Hunter Valley coal lines was attributed zero value for financial purposes. However IPART made it clear that the DORC valuation was to apply to the whole network and that the zero valuation was a reflection of the then current status of traffic on the network. There is nothing in the NSW Rail Access Undertaking that would exclude a full DORC valuation of other parts of the network if a traffic able to pay at the maximum regulated rate were to arise. This issue demonstrates the difference between accounting values that are held on an infrastructure

² DORC means depreciated optimised replacement cost and is a valuation methodology often used in the regulation of rail networks in Australia,

owner's books and the DORC valuation used for determining maximum infrastructure charges – in practice the two have nothing in common and are used for fundamentally different purposes.

As discussed in the draft report, typically, rail pricing is regulated so that the maximum price is determined on the basis of the stand alone cost of providing the network.³ The cost allocations for freight are subject to a form of Ramsey pricing. Thus, for example, certain minerals traffics might be charged a higher access price for use of a particular part of the network than a general freight service.

The draft report is correct in identifying that some parts of the network are not sustainable, even on a marginal cost basis, purely from access charges. An example of this is many of the grain branch lines around the country. However, for much of the network rail freight pays more than the marginal costs of providing the network. This can be seen for example in that:

- Access regimes around the country require access charges to be at least the marginal cost of providing access and charges are, for the most part, significantly in excess of the marginal costs, and
- ARTC has been reporting underlying profits (net of any government grants) since its inception, therefore clearly gaining revenues in excess of its marginal expenditures on rail access (ie not taking into account the sunk costs of providing the network).

An equivalent PAYGO analysis of the ARTC network (prior to the acquisition of the NSW network) is provided in Table 2 to provide a direct comparison between road and rail under this system. It can be seen that rail (predominantly freight) over recovers against expenditure in two of the three years that data is available on a comparable basis, far more so than road freight.

TABLE 2: EQUIVALENT PAYGO CALCULATION FOR ARTC EAST-WEST NETWORK

	2000	2001	2002	2003	2004
Access Revenue	87,649	86,181	87,853	92,479	100,411
Recurrent expenditure	66,784	61,673	66,650	67,843	77,033
Capital expenditure	44,811	26,980	17,488	11,490	13,751
Total cash expenditure	111,595	88,653	84,138	79,333	90,784
3 year rolling average – equivalent PAYGO charge			94,795	84,041	84,752
Access revenue compared to PAYGO equivalent			-6,942	8,438	15,659
% recovery			93%	110%	118%

Source: ARTC Annual Reports

Given the incompatible methods of cost identification between the two modes, it is most unfortunate that the Commission has decided to conduct its analysis on this basis. The resulting conclusions in the draft report are that road freight adequately pay its way whereas rail does not, and therefore that road freight is a more economically efficient transport mode. However, the comparison of the costs of road and rail infrastructure is flawed because the basis of the comparison is fundamentally inconsistent. Road freight is evaluated on the basis that it covers its marginal costs plus makes a small contribution to common costs while rail is evaluated against the full economic costs of providing the infrastructure on a stand alone basis. The true fact is that both road and rail freight, with some exceptions in both cases, cover their marginal costs and make some contribution to fixed costs.

³ In practice this means that there is both an individual ceiling price for any given traffic and a combinatorial ceiling revenue for all traffics on that part of the network in aggregate.

4.3 MODAL SHARE MODELLING

The results of the elasticity modelling conducted by the Commission are surprising. In essence the Commission's conclusion from the modelling is that road user charges are irrelevant to modal choice with even a 40% increase resulting in a minuscule modal shift to rail. This result arises because road user charges represent around 3% of road costs. Presumably other cost elements such as increases in fuel prices (excluding excise charges which are included in the user charge) would have a much greater impact given that these are around 5 times the cost of road user charges to a road operator and it would be illuminating if the Commission was to provide a comparative analysis of the effect of changes in fuel pricing to validate its conclusions against recent real world experience.

It is understood that the purpose of the modelling was to consider the impact of changes in road prices rather than the effect of other matters that might impact modal share. From the summary of the modelling provided in the draft report it appears that the model is based solely on changes in prices and input quantities (eg labour) and does not recognise the impact of changes in service quality.

Pacific National's understanding from extensive day to day interaction with customers is that rail's ability to contest for the intermodal market is dependent, not surprisingly, on service quality, combined with price. In this sense, service quality is referring to issues such as transit time, reliability of arrival time and product damage, ie there is a significant service elasticity as well as a price elasticity. Rail has essentially competed with road on an alignment derived in the early 20th century whilst massive investments in the interstate road network has resulted in a high quality route, bypassing towns, increasing axle limits and pavement standards. In addition road freight is not constrained by curfews during peak times in urban areas.⁴ In this environment, rail's market offering has continued to decline compared to the road equivalent even though priced lower.

Thus, on the one hand, rail is finding it difficult to attract market share while on the other it is seemingly burdened with a high cost, low performance infrastructure while competing with road freight that pays little more than marginal cost for an increasingly attractive infrastructure. If interstate rail continues to compete with its current alignments it will eventually cease to exist on some routes. The message that the market share modelling provides is that, if the current price/service relationships remain constant, the answer does not lie in changing road user charges – this has virtually no effect.

However, if the service paradigm is fundamentally altered, Pacific National suggests that it is likely that the sensitivity of modal share to price will rise significantly. It is the stated aim of the Australian Transport Council to put rail into a position such that it can compete effectively against road. This is also the focus of the current investment by ARTC in the interstate rail network.

Thus the basic conclusion of the Commission from the elasticity modelling is grounded on a false assumption that the existing service/price relationships between road and rail are in a steady state and therefore predictive of future market behaviours.

If both the grounds for evaluating competitive neutrality (the cost recovery comparisons) and the effects of a lack of competitive neutrality (the modal share modelling) are both seemingly flawed, the whole basis of the Commission's position must be called into doubt.

⁴ It is recognised that a form of "curfew" arises through the time penalty incurred by road vehicles progressing through peak hour traffic and that therefore trucks will try to avoid travelling in cities during that time, however this is a choice that is available to road freight that is not available to rail where absolute curfews are applied by the infrastructure provider.

4.4 GREENHOUSE GAS EMISSIONS

Studies have shown that rail has a significantly lower emission of greenhouse gases compared to road for a given freight task. The following extract from a recent Australian study demonstrates this point:

“The study ... examined the performance of road and rail modes for transport of general freight in seven long-distance corridors in Australia. The corridors are typical of those served by the Australian interstate freight industry, ranging in length from approximately 600 to over 4,000 kilometres.

In all cases examined in this study, the rate of emissions from intermodal [rail] freight (measured in grams per net tonne-kilometre) was substantially less than from direct road freight. for all types of trucks.

The emissions from intermodal [rail] transport were between 31% and 54% of those from 6-axle articulated vehicles, and between 41% and 70% of those from 9-axle B-doubles.”

(Extracted from the Executive Summary, page vi of the study “Comparison of Greenhouse Gas Emissions by Australian Intermodal Rail and Road Transport” Affleck Consulting Pty Ltd, October 2002.)⁵

However, the draft report has effectively ignored this difference, instead suggesting that it would be inappropriate to price these emissions for transport in the absence of a comprehensive policy approach from government.

While it is acknowledged that unilateral action in the Australian economy can have the effect of moving economic activity off-shore, it seems inappropriate to dismiss this issue on that basis. Any unilateral decision making (including not making decisions) in the Australian economy has impacts both domestically and overseas. It is inappropriate to refuse to address an issue because of the potential off-shore impacts. On that basis, the Commission ought to report to COAG that it is not appropriate to make any recommendations on any matters relating to transport infrastructure pricing at all as this will have flow on effects on the economy and may lead to external impacts!

This treatment is a further demonstration of the problem that arises from the narrow consideration of the relative economics of the two modes. Ignoring the benefits from reducing greenhouse gases in the economic evaluation further supports the erroneous conclusions that there are no competitive neutrality issues between road and rail and that the latter is an economically inferior transport mode. Rather, Pacific National is of the view that it is important for the Commission to recognise the cost to the economy and the wider social impacts of global warming in the context of this study and to advise government on appropriate ways to address the issue as far as infrastructure pricing is concerned. If the Commission believes it is necessary to warn of the need for governments to consider the wider impact of a particular measure, then there does not seem to be any impediment to giving such a warning.

A further matter that received no consideration at all in the draft report is that rail freight is more fuel efficient than road. This not only impacts greenhouse gas emissions and pollution generally, but also in an environment where there is growing concern that world oil resources are dwindling, one would expect both from an economic (eg fuel price) and social (concern to protect finite resources) perspective that this would be factor in favour of preferring rail transport over road. If the economic analysis provided by the Commission is not capable of factoring in this type of consideration, it is surely essential for the Commission to recognise such shortcomings in its final report.

⁵ The full paper is available from the Planning And Transport Research Centre website at www.patrec.org/conferences/Previous_PATREC_Seminars_2003.html

5 CONSEQUENCES

Ultimately, the issue is not whether road or rail is “paying its way”,⁶ it is whether each mode is able to provide the level of service and satisfy demand for transport services at prices available in the market while meeting all other social and “non-economic” demands from society.⁷ A “static” economic analysis may not be capable of answering this question definitively.

For example, if policy is driven simply by an unqualified requirement for full economic cost recovery respectively by each of the two transport modes, this might conceivably lead to:

- A substantial increase in rail infrastructure charges, and
- Abandonment of rail services in some regions and some trunk routes,

due to a wholesale move from rail to road.

To draw out this example, it is quite clear that access charges and hence freight rates would need to rise drastically on most, if not all, grain branch lines around the country to meet the economic cost of providing that infrastructure. One of two consequences would arise;

- grain would move to road transport, or
- farmers would cease producing grain.

In most instances, the only purpose for retaining the grain branch line networks around Australia is to carry grain and these lines for the most part would be abandoned. In a few instances where other commodities are carried on those lines, this is likely to have a flow-on effect to other economic activity in regional areas such as mining – in some instances heavy minerals do share lines with grain traffic. A requirement for full cost recovery combined with the loss of grain traffic on such lines would cause increases in the cost of these other traffics as well to cover the infrastructure revenue shortfall and potentially cause these residual traffics to be priced off rail and potentially out of production as well.

Considering the north-south rail corridor between Melbourne-Sydney-Brisbane, if this corridor is required to compete on the basis of self-funding of the full economic cost of the infrastructure, rail will almost certainly continue to decline as service levels will continue to deteriorate in comparison to road. Existing returns to both above and below rail operators are not currently sustainable and only massive increases in market share will deliver anything like a sustainable business into the future.⁸ Even under that scenario, it is not clear that the investment required above-rail to achieve this could be supported, even if the below rail investment is self-funding. The achievement of anything like self-sustainability is predicated on a substantial decrease in transit times such that rail is able to attract more of the time-sensitive freight that is currently on road. Without significant investments in both above and below rail the service requirements for rail will not be met, but these investments are not going to be forthcoming from the private sector if the commercial risks about the likelihood of modal shift occurring are not matched by appropriate returns. If rail infrastructure access charges are expected by above-rail operators to move up to cover economic costs regardless of the actual volumes achieved, they will be wary of investing, thereby fulfilling their own pessimistic expectations. There will be no incentive to invest in a business that is not currently earning reasonable returns and there is a potential for the infrastructure owner to extract what little profit is available (ie through

⁶ except perhaps from an ideological perspective.

⁷ For example even if rail is not a public good, there may be elements of the service that have public good aspects to them. Similarly political considerations may not be amenable to economic analysis but are nevertheless often genuinely representative of the aspirations and expectations of communities and therefore should be recognised as legitimate. It is not society's problem if economics is incapable of measuring it accurately.

⁸ Analysis by ARTC indicates that the north-south corridor infrastructure will reach economic rates of return with approximately double current market share. As the market is expected to double in size over a similar period, this represents a four-fold increase in volumes.

quasi-rents). Rather there is a significant risk that such investment will not be forthcoming and rail on the eastern seaboard inter-capital routes will wind down as operators maximise cash returns from sunk costs but fail to invest in new equipment.

Such a scenario is likely to have a significant impact on road investment and, in particular, modify the relative proportions of heavy vehicles and passenger vehicles. The total costs of roads, in terms of investment, congestion and maintenance costs would rise to such an extent that the ability to apply high (relative) prices to passenger vehicles through Ramsey pricing will become constrained, forcing a much greater allocation of costs to road freight. It would be a most useful addition to the Commission's analysis for such a hypothesis to be tested.⁹

6 WHY DO WE WANT A RAIL SYSTEM?

The Commission's analysis is that:

- road pricing is not unfairly impacting rail market share of the land transport market (ie there is no impact on competitive neutrality), and
- even if this is not true, the proportion of costs that road freight pays for infrastructure are so small compared to rail¹⁰ that substantial increases will have negligible effect on market shares¹¹,

The Commission also rightly identifies that rail does not pay the full economic cost of its infrastructure in the non "heavy haul" sectors.

When all is said, the draft report is clear. In the commission's view, road infrastructure pricing is not the cause of rail's problems and the solution needs to be found elsewhere. Regardless of what is done to road infrastructure pricing, it will not have any real effect on rail market share or rail economics.

While the draft report does not explicitly suggest that rail necessarily should "pay its own way", it does question the economic rationale for governments continuing to subsidise rail infrastructure through, for example, accepting low returns. It seems clear that the Commission is questioning why governments would want to support rail freight where it is unlikely to generate economic returns when there is a viable alternative (ie road freight or coastal shipping) that does generate economic returns, presumably in most cases.¹² This is an appropriate question to raise, and policy makers will need to carefully consider other issues, in the social, political and risk areas which demand the continued support of a general rail freight network in spite of the lack of economic self-sustainability.¹³

It is certainly not clear why rail freight would be a less economically efficient mode than road where it is able to operate over reasonably long distances with trains of substantial scale. However, even where rail appears to do well in terms of market share (apart from the heavy haul minerals) such as the east-west corridor, the returns to the infrastructure provider are less than the full economic costs. This is not merely a matter of whether access charges are too low, allowing above-rail operators to earn above normal profits. Any attempt to raise access charges is more likely to result in a realignment of the revenue take between above and below

⁹ While road and rail infrastructure pricing will always be, of necessity, somewhat in the form of a "natural experiment" it would be unfortunate if the result was that the subject of the experiment was destroyed.

¹⁰ In broad terms infrastructure costs represent around 3% of road vehicle costs and 30% of rail costs.

¹¹ While Pacific National does not wish to belabour the point, it does beg the question as to why this insensitivity to pricing should not result in the application of Ramsey pricing principles to raise truck prices. The result does seem somewhat contrary to the fevered debate that accompanies heavy vehicle pricing determinations – why are the trucking companies and the politicians so worried if the Commission's results are so robust?

¹² The Commission acknowledges that its conclusions on road pricing are based on average outcomes and that there are cross-subsidies within road pricing that the Commission has not had the opportunity to specifically identify. This is one of the reasons the Commission is seeking to reform road infrastructure pricing.

¹³ While the Commission's consideration of the economics has provided useful analysis, it is clear that such a complex issue calls for a far wider-reaching consideration than time allowed.

rail, not an increase in the overall revenue available to rail in total. Coastal shipping appears to provide a competitive alternative thus constraining rail pricing even in circumstances where road competition does fail to match rail economics. Policy makers will want to have a clear understanding of why rail is in this position before taking decisions that might lead to a substantial reduction in the rail network.

This leads Pacific National to two conclusions:

- a great deal of additional work needs to be done to understand the relative efficiencies of road and rail (and other transport modes) and the reasons behind this in order for policy makers to be in a position to make informed decisions about transport investments, and
- if governments wish a healthy rail freight industry to continue they will need to enter into partnerships with industry to facilitate the substantial investments in rail infrastructure required to deliver the service capabilities required to compete with road.

7 A WAY FORWARD

Notwithstanding whether the Commission has performed the analysis and interpreted the results correctly, the initial basis of the terms of reference is somewhat moot. The motive underlying COAG's desire for the Commission to consider the matter appears to have stemmed from a view that an imbalance between road and rail user charges are the key to achieving two policy aims:

- getting trucks off the roads, and
- placing both modes on a self funding basis for their infrastructure requirements.

Under any view of the Commission's analysis, it is clear that neither mode is anywhere near self funding on a stand-alone basis and therefore merely changing infrastructure access prices will be insufficient to achieve those policy aims unless one were to could pricing changes of orders of magnitude. The Commission appears to have discarded the possibility of changes of that magnitude.

So if the answer is not a simple reordering of road user charges, and it is not appropriate to divest the country of its non-bulk rail freight capability, then what is the solution? The problem for both road and rail is how to provide an appropriate level of funding such that the infrastructure required to service projected demand is provided.

Pacific National suggests that an appropriate model exists in the Swedish approach. This approach is based on:

- A commitment by government to fund both road and rail infrastructure capacity investment.
- Pricing of infrastructure access for both modes at marginal cost.
- Evaluation of investment programs for both modes on consistent criteria through a central agency.

As this model bases infrastructure pricing to users on a marginal cost basis, it provides appropriate pricing signals between modes. In turn, combined with an appropriate service capability for both modes this ought to lead to efficient modal choices by freight transport consumers.

8 RESPONSE TO SPECIFIC QUESTIONS RAISED

The draft report raises a number of issues on which the Commission seeks further advice. Below, Pacific National responds to those matters directly related to rail matters. Pacific National is supportive of the ideas raised by the Commission with regard to the need to review

both the method and quantum of road freight infrastructure charging but is not in a position to offer specific comments on these matters except to note that any structural change should incorporate the need to consider public investment in land transport on a holistic basis rather than segregating such decisions to individual modes.

8.1 EFFICIENT ALLOCATION OF COMMON COSTS OF PROVIDING RAIL INFRASTRUCTURE

“The Commission seeks comments from participants on approaches to achieving an efficient allocation of the common costs of providing rail infrastructure.” p.5-12

Rail infrastructure providers around the country have set access charges in a variety of ways and price discrimination does occur. Almost invariably regulators have allowed providers the discretion to discriminate on price. However such discrimination has been exercised on the basis of the type of task (ie different types of traffic), not between train operators performing similar tasks. This is because a key concern in making third party access available (whether through vertical separation or merely making access available alongside the integrated entity) is to facilitate competition to provide above-rail services. In order to achieve this, without introducing arbitrary distortions and aberrant behaviours, access providers should provide access without regard to the identity of the above-rail operator other than taking into account normal commercial risk considerations (eg the ability to pay for the service provided). Further, it is difficult to provide any type of pricing incentive (eg volume discounts) that might apply in less contrived markets that do not favour either incumbents, larger operators or both, to the detriment of new entrants, who are the very parties that third party access is intended to assist. If one seeks to steer pricing in the direction of small operators (eg through volume disincentives), this is likely to be perceived as unfair and will attract artificial behaviours from larger operators (eg through sub-contracting to created new subsidiaries) to take advantage of the lower price. Thus price discrimination between operators performing the same task is not really practical nor is it clear that it is at all desirable.

Price discrimination based on task has been practiced widely in most jurisdictions. For example, in NSW, different prices apply to a variety of traffics such as coal, mineral ores, other bulk traffics and intermodal and grain traffics. In Queensland, QR differentially prices access for its coal traffics from general intermodal business. ARTC charges different rates for different axle mass and speed combinations on the interstate network.

As the Commission has pointed out, care needs to be taken in applying Ramsey pricing principles. Access providers are usually at least one stage removed from the end rail customer and there is a significant risk of misunderstanding the true elasticity of demand for the end customer.

Therefore, Pacific National would suggest that, at the broad level, Ramsey pricing is freely available to track owners and is already being practiced. Price discrimination between operators is available in some jurisdictions, but to Pacific National's knowledge is not being practiced because of both the conceptual and practical difficulties that arise. If this is the case, it would appear that, to the extent that track owners are able to recover common costs, they are probably already doing so quite efficiently.

If the question posed by the Commission is about the specific structure of access charges, Pacific National suggests that this is a matter best left for consideration in the particular circumstances. A variety of charging mechanisms currently apply for various traffics in different jurisdictions. For example ARTC charges:

- a two-part tariff for the interstate network with individual rates for each part determined on a line sector basis,
- a rate per tonne for each origin – destination combination for coal traffics,

- a rate per gross tonne kilometre for several origin – destination combinations for some minerals traffics.

QR sets four-part prices (excluding electricity related charges) for coal traffics on the basis of a variety of service characteristics.

It is important to note that, where fixed and variable components are set, these are not necessarily related to the relative proportions of fixed and variable costs to provide access. Thus the fixed component of ARTC's intermodal charges (approximately 25% of the total) bear no relationship to the 75% of ARTC's costs that are fixed. Thus Pacific National sees the fixed component in this context as a path reservation fee that is designed to discourage hoarding of train paths without use rather than any attempt to cover fixed costs.¹⁴ In practice, if ARTC moved to reflect its cost structure by adopting the same proportions in its fixed charges, this would probably be a more significant barrier to a smaller operator or new entrant and favour a larger operator that was able to be more certain of having a payload for a train. It is therefore unlikely to be attractive to either track owners seeking new entrants, nor the new entrants themselves and would seem contrary to the intent of allowing third party access.

In Pacific National's view, existing access charging structures do not have any substantial negative effect on efficiency or traffic volumes and there is no obvious alternative that would lead to a more efficient allocation common costs.

8.2 IMPACTS OF VERTICAL SEPARATION & INTEGRATION ON REGIONAL & INTERSTATE LINES

“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.” p.10-13

In responding to this question, Pacific National has also considered the success or otherwise of vertical and horizontal integration and separation in achieving the purpose of third party access ie competition between train operators. This is discussed below in Section 8.6.

Vertical separation has the potential to introduce substantial interface costs, financial, qualitative and in management resources. However, the case should not be over-stated. Even under pre-third party access structures, vertically integrated railways often found significant difficulties managing intra-organisational interfaces, so it should not be assumed that reintegration would necessarily removal all such difficulties. Further, the horizontal separations between track owners add significantly to the coordination efforts required to operate trains across different networks. Any consideration of the impact of vertical separation should also recognise the impacts of horizontal separation.

Pacific National's experience with vertical separation (and in dealing with its own 'ring-fenced' access provider in a vertically integrated environment) is that the opportunity for dispute, discord and dysfunction is amplified. This arises through several factors:

- Differing organisational objectives
- Differences in performance expectations (eg one party might be interested in how efficient the network is operating as a whole while the other might have a greater interest in a specific train)
- Differences in world view eg one party might see itself taking on a pseudo-regulatory or leadership role that is contrary to views of the other party
- Lack of structural compatibility (ie if one organisation has a structure that does respond well to the management structure of the other)

¹⁴ By way of contrast, Network Rail in the UK charges freight around 75% of access charges as a fixed fee to reflect the fixed costs of proving the network. For passenger services this rises to around 90%.

In a unified structure, while many of these matters might arise between different divisions, the ability of resolve these differences is significantly aided by the availability of a single decision maker at the apex of the structure (eg the Chief Executive Officer). This by no means removes dispute, but it ought to prevent these matters becoming crucial to performance and ultimately the organisation can point to a single set of objectives against which all issues can be assessed.

By contrast, in a vertically separated structure, there is no internal mechanism to resolve such matters and there are likely to be conflicting objectives between the two entities even though some objectives might be common. While access contracts typically have dispute resolution mechanisms, these are usually formal processes and are unwieldy for everyday use. Thus the relationship is likely to be more frustrating for both parties as they struggle to resolve the myriad of details that form the relationship without effective methods for resolution of conflict. This can be contrasted with the equivalent relationship on a road network where the road user has virtually no day to day contact with the road provider and therefore the management of a relationship is not an issue except at the strategic level eg where a user seeks investment or a change in road rules. There is no trip planner, no train controller, no unresolved commercial issues over which to tangle.

A specific example of the types of problem that can arise is the management of train paths. In the NSW Hunter Valley it was clear that the separation of planning for the various components of the coal chain was dysfunctional for the productivity of the chain as a whole. This was not just a rail separation issue but also included the interfaces with the port. The solution that was found there was to form a unified planning group across the various entities that was directed at removing the impacts of separation. While this has worked very well for all parties, it is a solution that was hard won and requires a substantial level of maturity from all participants as the solution inevitably requires choices to be made on a daily basis that might not suit one or more parties. To Pacific National's knowledge, this solution has not been replicated elsewhere on Australian rail networks.

Another area of difficulty that arises from vertical separation in rail (as in road) is the determination and implementation of investment. In rail, investments may be made both above and below rail that have an effect on each other, to a much greater extent than applies to the road network. For example, the hauling power of locomotives will, to some extent, determine the optimal train size, but so also will the capability of the infrastructure for example through the length of crossing loops. Investing in locomotives that do not well match the infrastructure well will be inefficient and similarly investing in infrastructure that is not capable of being used to best advantage by the available rollingstock. Thus it is imperative that investments above and below rail are closely coordinated and matched. But vertical separation places an impediment in the way of achieving this. Added to this difficulty is the complexity of making investments that have an impact (eg cost savings) both above and below rail. While, in some instances, it might be possible through agreement to make appropriate arrangements, this is often difficult to achieve.

An example will illustrate the difficulties. Suppose a train operator wants to run longer trains. To do this requires longer crossing loops, a below rail investment. The operator might be willing to fund these directly, but to do so introduces complexities in setting access charges for both the operator and the track provider – what if another operator wants to take advantage of the longer loops. Also it is complex from a taxation and corporate governance perspective for the operator to invest directly in infrastructure that it does not own. So it makes sense for the track owner to make the investment. But if the track owner has a different view about what investments to make, about the risks associated with the longer cross-loops etc, it might not be willing to undertake the investment. Conversely, lest one think that this is a lop-sided example, consider the network owner in a situation where it wants to adopt a new signalling system. To do so requires operators to incorporate certain equipment in their locomotives. What if one or more operators can't or won't do this? Should the network owner be able to force the operator to do so for the greater benefit of all? Should the network owner and other operators on the network be subject to the decisions of a single operator? While there are likely to be solutions

to such issues, they are inevitably complex and require either unpalatable compromises or else impose obligations that would not be tolerated in a normal commercial relationship.

These types of difficulties are not such a problem to a vertically integrated entity, the matter is resolved somewhere in the organisation, presumably for the greater good of the entity, regardless of the outcomes for individual parts of the firm.

From Pacific National's perspective, these problems arise not just in vertically separated entities but also, though perhaps to a lesser extent, where ring-fencing applies to integrated firms. The problem lies in being required to artificially segregate a part of the business that is closely linked with other parts. Pacific National is not aware of any research that has considered the transaction costs that arise within railways through separation compared to the operation of roads and it is suggested that such research would be important in considering how best to structure railways into the future. However Pacific National's experience confirms the intuitive expectation that the high degree of interaction between above and below rail leads to a need for a high degree of cooperation that is more difficult to achieve in vertically separated or ring-fenced firms.

Similarly these problems arise in relation to the horizontal separation of networks and this is discussed below in Section 8.6. It is noted that, when ARTC was set up to operate portions of the interstate rail network, COAG agreed that it would operate a "one stop shop" to sell access to the entire interstate network. Despite the good intentions of all parties and the expenditure of much effort, this has not come to pass. Thus it is now a requirement for a train running from Brisbane to Perth that the operator hold four access agreements (assuming it passes through Sydney) instead of one. This is in addition to the requirements for accreditation with each State based rail safety regulator.

8.3 DESIRABILITY TO MOVE TO A SINGLE NATIONAL REGULATOR

"The Commission seeks comments from participants on the desirability of moving to a single national regulator or regulatory regime for rail infrastructure." p.10-22

It is noted that COAG in February 2006 agreed to seek consistency in rail regulation. This is a welcome aspiration. The current system of regulation whereby each State and the Commonwealth all practice the imposition of some form of regulation of rail appears to bring little benefit and much duplication of effort.

It is, however, somewhat disappointing to Pacific National that the COAG reforms merely look to a replication of regulation among the various regulators rather than a rationalisation thereof. The result of attempts at uniform regulation in Australia is often *near* uniformity, but with sufficient diversity as to wreck the intent. Even where there is uniformity, this does not necessarily mean uniformity of interpretation and so the benefit of uniformity is diluted as differences emerge over time.

In this environment, Pacific National sees substantial benefit in moving to a single, national regulator for rail access arrangements. However, it must be understood that a national approach should not be taken to mean that a single set of criteria should apply in all circumstances. To the contrary, it is clear that different circumstances do require different responses. Some traffics require a very different approach to others across a number of areas eg path allocation, investment and pricing. It is for this very reason that Pacific National is supportive of ARTC's approach to put forward two access undertakings for its network, one for the Hunter Valley coal and one for the rest of the ARTC network.

In its February 2006 meeting COAG agreed that the existing ARTC Undertaking with the ACCC was the model on which all other rail access undertakings should be based. Pacific National is concerned that the ARTC model, in its current form, has a number of short-comings and in

particular that it is ill suited as a basis for the regulation of some traffics without substantial modification. Any move towards uniformity of regulation would do significant harm to the rail industry if doing so required the industry to fit a single model rather than access regulation being designed to accommodate the needs of the relevant parties on the basis of consistent broad principles.

8.4 REMOVAL OF REGULATION

“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?” p.10-23

The Commission has asked the reasonable question, if rail is constrained in its ability to price due to competitive pressures, is there a need for access regulation, at least where there is vertical separation such that there is no interest in discriminating between train operators?

If the question was one directed solely at narrow economic considerations, then Pacific National would agree that, *prima facie*, there is little value to be gained from regulation of the track provider where there is a strong competitor except where there is the potential for the infrastructure owner to extract quasi-rents. This can be seen in the current pricing approaches on the interstate corridor where prices are far below the “ceiling” allowed by the regulator.

However, access regulation in Australia has been directed to a number of issues, of which pricing is but one. Access regimes and undertakings routinely set out the relationship between the track owner and train operators; they deal with matters such as:

- Negotiation of access agreements,
- The terms and conditions in an access contract (often including a standard access contract),
- Dispute resolution processes,
- Pricing and escalation arrangements,
- Obligations with regard to investment and connection to the network.

It is therefore not a simple matter that the constraints of pricing regulation are redundant, these other matters are of vital importance to train operators. If these are removed, it would significantly increase the ability of the track owner to impose its own arrangements on train operators large and small.

The negotiate and arbitrate model is predicated on an effective negotiation process with arbitration as a fall back. If the negotiation process is hindered through an imbalance in the negotiating positions of the parties (remembering that, regardless of the position of end customers and their competitive alternatives, train operators are effectively captive to the track owner) then the only recourse is to arbitration. But arbitration is a singularly ineffective process for dispute resolution in most instances. It is costly, time consuming and the outcomes are far from certain. Given that the train operator has no alternative to using the track owner’s asset (except to not run trains) it is a highly unattractive proposition for a train operator to seek to enter formal dispute resolution processes and therefore arbitration becomes an extremely poor constraint on the behaviour of the track owner.

While arbitration currently sits as the option of last resort under current regulatory processes, the existing undertakings and regimes do set out certain processes and obligations that provide a known framework for any party seeking to negotiate access. This framework has been scrutinised by a third party (usually a regulator though it might be a government department eg

as in NSW) and therefore at least has the benefit of being considered a fair balance between the parties.¹⁵

Pacific National therefore sees significant value in retaining regulatory oversight of track owners, notwithstanding that pricing might not always be constrained by the normal regulatory limits.

It is unclear whether the Commission is suggesting merely the removal of current regimes and undertakings and reliance on the general Part IIIA Trade Practices Act provisions for seeking declaration, or considering removing certain parts of the interstate network from the ambit of Part IIIA altogether. However these comments would apply in either case.

8.5 PERFORMANCE OF GOVERNMENT OWNED RAIL INFRASTRUCTURE PROVIDERS

“The Commission seeks participants’ views on the performance of government-owned rail providers.”
p.10-28

It is unclear to Pacific National from the draft report that infrastructure owners, whether government or privately owned have been acting in an “uncommercial” manner. The fact of the matter is that no network, outside of the NSW and Queensland coal networks could conceivably operate at the ceiling rates of return that regulators have allowed under existing traffic levels and the competitive environment. It therefore remains for network owners to recover what they can and Pacific National is not aware of evidence that they have “left money on the table”.¹⁶

In this circumstance, the inability of track owners to attract funding, whether through equity or debt is hardly surprising. So it is also unclear why the Commission sees this as a failing of the track owners. In Pacific National’s understanding this goes back to the findings of the draft report that rail is an uneconomic proposition for the most part. To this extent, failure to invest is a rational response to the problem.

Similarly, Pacific National is not aware of significant government interference with track owners, perhaps with the major exception of the obligation to retain certain lines for example grain branch-lines. This is an area where governments have found it difficult to arrive at a definitive view (certainly in the eastern States) and in the absence of a clear policy direction neither adequate funding nor a relinquishing of the reins has occurred, leading to grain lines becoming moribund through indecision.

To the extent that the network is subject to government influence, it appears that the issue lies more with governments than with track owners. In this context, it is possible that the inclusion of clear objectives in the constitution of track owners might assist. However, experience indicates that such measures might be more honoured in the breach than that they provide any realistic benefit. Government policy is determined by a wide range of matters and will not be seriously constrained through being inconsistent with the objectives of an owned entity. It is usually the case that a government owner will reserve the right to direct an entity (whether as government or as shareholder) and therefore attempts to quarantine a government owned business are only ever partially effective.

¹⁵ It is recognised that regulators make such determinations within the constraints of their jurisdiction eg under the Competition Principles Agreement, the regulator is required to take certain criteria into account when considering undertakings and therefore the regulator does not have carte blanche in determining whether to approve an undertaking.

¹⁶ With regard to the Commission’s view that track owners have been receiving low returns, this is not necessarily the case. Where the infrastructure has been sold to another party at below its DORC value, the owner may well be receiving satisfactory financial returns – it is the original owner that has received the poor return, similarly where governments have “gifted” the network to a corporatised entity that has received the asset into its accounts at an appropriate financial valuation.

Further, Pacific National would argue that government participation in rail infrastructure is not a negative, but in fact essential, as the Commission itself identifies. While commercial disciplines are useful in structuring the delivery of infrastructure services, if the economics of rail are such that it is not able to become a self-supporting business, then it is a major error to expect that the adoption of a private commercial model will somehow overcome this obstacle.

Governments have generally recognised that rail infrastructure, like road infrastructure, is an enabler of economic activity and therefore is to be supported. Any management model for rail networks must accommodate this.

Pacific National would certainly agree with the Commission that where governments are seeking to direct funding to achieve specific outcomes that these outcomes should be clearly articulated and where appropriate, contracts or other instruments used to document the intentions of the parties.

8.6 COMMENTS ON REINTEGRATION OF THE RAIL NETWORK

“Draft Recommendation 11.5

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.”

“The Commission seeks the views of participants about the potential costs and benefits of reintegration on specific rail networks.” p.11-5

Vertical separation of rail networks was one response to a desire to introduce competition on the above-rail part of the rail transport task (both freight and passenger). Another response was to retain vertical integrity but put in place measures to allow third parties to compete with the incumbent for example through the use of a separate corporate structure (eg WestNet when owned by the Australian Railroad Group) or the ring-fencing of the part of the organisation dealing with infrastructure access matters such that it interfaces with the “parent” in the same manner as with a third party seeking access (eg QR in Queensland, PN in Victoria). In all cases, there has been a considerable effort made through regulation to ensure that the separation is effective and not merely a sham.

Experience is that third parties have approached vertically integrated track providers with a degree of scepticism as to the effectiveness of ring-fencing measures, though Pacific National is not aware of any particular case where such scepticism has been tested and found justified. However, whether such measures are effective or not, the perception that they are less than 100% effective remains.

If there are different models as to how to implement competition policy, it is instructive to consider where competition has arisen and how effective each model has been. Pacific National takes as a given that vertical separation without a competition objective introduces substantial interface costs, is structurally inefficient and would not be contemplated except where the owner believes it is necessary for the benefit of better managing investment or other policy objectives.

Direct competition between train operators has arisen in NSW (RailCorp, RIC, ARTC) and on the interstate network (owned variously by QR, ARTC, RailCorp, WestNet). It could be argued that competition has arisen on the QR narrow gauge network, but Pacific National suggests that this is a special case and not genuine competition.

These examples would indicate that at least some competition has arisen on vertically integrated networks. However, Pacific National's view is that this impression is false, or at least, misleading as an indicator that competition occurs on vertically integrated rail networks.

Competition on the vertically integrated parts of the interstate network was, until very recently, not competition between the incumbent integrated owner and third parties. It was competition between third parties only as the track owner was not seeking to provide relevant services on those lines. WestNet, QR and RailCorp were not seeking to run interstate freight services and therefore the incumbent was a third party train operator. Admittedly this has changed in the last two years with QR now competing on its standard gauge interstate track and this, perhaps, is the only true example of third party competition with an integrated owner, recognising that this accounts for 100 km of track between Brisbane and the Queensland-NSW border. However, even in this instance, the presence of an incumbent third party prior to the owner commencing operations makes this a very different case to the circumstance where the vertically integrated owner competes against new entrants. As WestNet is now a separate entity from ARG, vertical separation has been achieved but even under the previous circumstance, ARG was not actively competing in the same markets (eg interstate intermodal movements) as the incumbent third parties and therefore there was no direct competition between the owner and third parties.¹⁷

In the case of Pacific National operating on QR's narrow gauge network, this arose not because the parties competed for the business but because the end customer switched its business to a related company, thereby effectively integrating the transport task and removing it from contestability ie vertical integration from the customer end rather than the infrastructure end. It is unlikely that this "competition" would have arisen had the parties merely been competing for the business of a third party. It is for this reason, that Pacific National does not see this as a real example of competition on a vertically integrated network.

Pacific National would therefore argue that allowing third party access on integrated networks is unlikely to generate competition between an incumbent and new entrants.

If competition has failed to prosper on vertically integrated networks, it has at least arisen in a genuine sense on the vertically separated networks. There is vigorous competition between various train operators in a variety of situations. Examples include:

- QRNational and Pacific National on several routes including Hunter Valley coal and interstate intermodal operations,
- SCT and Pacific National on the east-west route with the likelihood of at least one other party with the implementation of the undertakings given by Toll to the ACCC as part of the merger with Patrick Corporation,
- GrainCorp and Pacific National for various grain hauls,
- Several niche operators in the Sydney greater metropolitan area.

It is clear that, except where niche markets are available, there will not be a substantial number of train operators. Both QR and Pacific National have acquired and assimilated smaller rail firms over the last several years. This is not surprising given international experience. For example, in the USA, the major Class 1 railways have been merging over the last several decades. It has widely been speculated within the rail industry that Australia will ultimately have two or three major operators and a number of smaller niche or regional operators.

If this is the case, then the question arises whether the vertical separation model is still of value.

If vertical separation is to remain, then as a minimum, the structure needs to be put in place to minimise the costs of vertical separation. These costs are discussed in section 8.2 above and relate to matters such as achieving investment in the network, coordination of above and below

¹⁷ It could be argued that there was competition for capacity eg WestNet's related operator AWR ran trains on the same network as interstate operators and therefore potentially competed for train paths, but this is different to competing to supply the same end customer. However this is not the type of competition that was envisaged as the goal of third party access.

rail activities and the need for close consultation and cooperation between the parties to achieve efficient outcomes.

In the absence of clear mutual interest, such a structure is only likely to arise through regulation. Without appropriate regulation, experience has shown that it is very difficult to achieve the necessary cooperation and participation between entities. For example, if there is no obligation on the track owner to take into account the preferences and requirements of train operators in determining its investment program, this is left totally to the discretion of the track owner. This does not necessarily mean that the track owner will ignore its customers but the matter is totally within the hands of the owner. Experience shows that an entity that is not obliged to take someone else's views into account is not likely to place much weight on those views when contrary to its own views or objectives. Where the market fails to apply pressure to accommodate customer preferences, there is a need for a regulator to provide such pressure.

Reintegration provides an alternative structure. The USA model is one where each major railway owns tracks that are required by others. This leads to behaviours that seek out mutual benefit within clear contractual guidelines. This arises because each party is able to affect the other's operation and the alternative to mutual benefit is mutual destruction of value without either party being able to win.

In Australia this model will be difficult to implement as the conditions of interdependence between train operators are not generally present nor are they easily contrived. This is a particular problem with the different rail gauges around the country which make inter-network running an unviable proposition in a number of cases. In order for this model to work effectively there would need to be a further merging of interests. For example, it would not simply be a matter of merging Pacific National and ARTC to create a vertically integrated entity to compete with an integrated QR. A number of other parties have interests that would need to be taken into account, both as train operators and as track owners (eg SCT as an operator and WestNet as an owner). It is not clear how such interests could easily be safeguarded if vertical integration was considered.

A further issue that does not appear to be considered in the draft report is that of horizontal separation. This arises where a network is owned by different parties. The Australian rail network is fragmented among a number of different owners both public and private.

The problems arise when operators need to traverse between the track of different owners. This requires a substantial level of coordination and cooperation between the track owners and also the train operators. However, there is no relationship, commercial or otherwise, between the track owners and therefore no obligation to arrive at efficient outcomes for the network as a whole. This lack of cohesion can show in a number of areas for example:

- In the standards for the network (an obvious example is the different gauges around the country but there are many other more subtle examples – eg the variety of signalling and radio systems),
- The way in which train paths are allocated by each track owner,
- Indifference regarding the impact of decisions on operations in another network.

The track owners, while part of a wider system, rarely see the consequences of these decisions as the consequences are usually shouldered by the train operators. The train operators have little ability to seek cross-entity solutions except where the track owners are amenable through altruism to participate in joint solutions. Altruism, while a valuable part of the social structure, is not commonly found as a core objective in firms participating in commercial undertakings. Regulators, typically, are concerned with the direct relationship between the track owner and track users and have not, to date, found cause to regulate interactions between adjacent network owners. Thus, at present this is an area that is of significant concern to rail operators

but no obvious remedy presents itself unless governments and regulators are willing to deal with this issue.

Any consideration of vertical reintegration should also address the issues of horizontal separation (or integration) as without doing so would lead to only a partial solution.

While Pacific National sees substantial opportunity for improving the technical efficiency of rail from vertical and horizontal reintegration, it appears that this would come at the cost of competition unless other measures are taken to ensure effective competition. Under the current third party access model, experience indicates that competition will not arise (or be sustained) under vertical integration except where special circumstances prevail.