VICTORIAN GOVERNMENT SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY INTO ROAD AND RAIL FREIGHT INFRASTRUCTURE PRICING

1. Introduction

The Victorian Government supports the principle of efficient pricing of road and rail freight infrastructure where it can be shown that the benefits outweigh the costs.

Victoria notes that there will be transitional impacts for communities and businesses in implementing any changes. To address these issues, jurisdictions will require incentives. Funding linked to an independent assessment of progress has proven highly effective in ensuring that all parties commit to a reform process. The National Competition Policy (NCP) reform effort would undoubtedly have been far slower and less comprehensive without competition payments – a view supported in various reports from the OECD, the National Competition Council (NCC) and the Productivity Commission (PC). This will almost certainly be the case during the next wave of reform.

The Victorian Government believes that the Issues Paper is reasonably comprehensive and has responded to the spirit of the COAG Terms of Reference. The Victorian Government is hopeful that the Commission can progress the debate by highlighting the key issues in the neutral treatment of road and rail pricing.

In summary, the Victorian Government believes that pricing methodologies applied in road pricing, namely PAYGO, and the approach of the Victorian Essential Services Commission in determining rail prices, are broadly appropriate. However, potential neutrality issues arise from the allocation of costs to heavy vehicles and distortions caused by averaging data.

The Victorian Government particularly encourages the Productivity Commission to examine:

- the full cost of providing road and rail infrastructure;
- the appropriate cost base and parameters for developing road and rail charges for freight;
- the parameters for allocating costs to heavy vehicles and rail freight;
- distortions in competition between and within modes caused by averaging heavy vehicle data in terms of mass, distance and location;
- the extent to which the different pricing regimes affect competition between and within modes along the entire supply chain;
- whether the extent of any distortions within and between markets is so significant as to warrant the adoption of an alternative pricing principle, or whether these can be addressed by further development of the PAYGO model;

- inclusion of externalities in pricing for freight, including the need for, and availability, of Australian data on environmental and health externalities;
- the need for transition periods and incentive structures;
- the extent to which road or rail freight transport is a community service obligation particularly in remote and regional communities;
- whether terminal pricing practices make rail based supply chains less competitive;
- the timeframe for implementation of a new pricing regime for freight and whether interim arrangements will be required and what form will the interim arrangements take;
- whether the Third Heavy Vehicle Pricing Determination represents a move towards more neutral road/rail pricing; and
- the net benefits and impacts of reform, and options for transition, adjustment assistance, and mechanisms to facilitate reform that is shown to have net benefits.

2. Current Policy Context

The Victorian Government has been, and continues to be, supportive of improving efficiency and productivity in the road and rail transport industry, through both regulatory and operational means. Victoria's freight task is projected to more than double over the next thirty years.

The Victorian Government is supportive of increasing the share of freight transported by rail. In *Growing Victoria Together*, the Government has set a target to increase the proportion of freight transported to and from ports by rail from 10 percent to 30 percent by 2010. Commitments have been made to increase rail capacity and improve rail efficiency and safety. To this end, the Government has invested in a number of projects such as the Dynon Port Rail Link and the relocation of the Melbourne Markets to improve access to and from the Port of Melbourne.

The Victorian Government continues to support the work of the National Transport Commission (NTC) in developing regulatory reforms. Victoria's new rail safety framework is consistent with the national model and will be operable in July 2006, ahead of the COAG agreed deadline.

Victoria has implemented all available reforms under the Initial Reform Module, and the first and second Heavy Vehicle Reform Packages as well as nine of the eleven reforms available for implementation under the Third Heavy Vehicle Reform Package, more than any other jurisdiction.

3. Current Approaches to Road and Rail Pricing

3.1 Road Pricing - PAYGO

3.1.1 Background

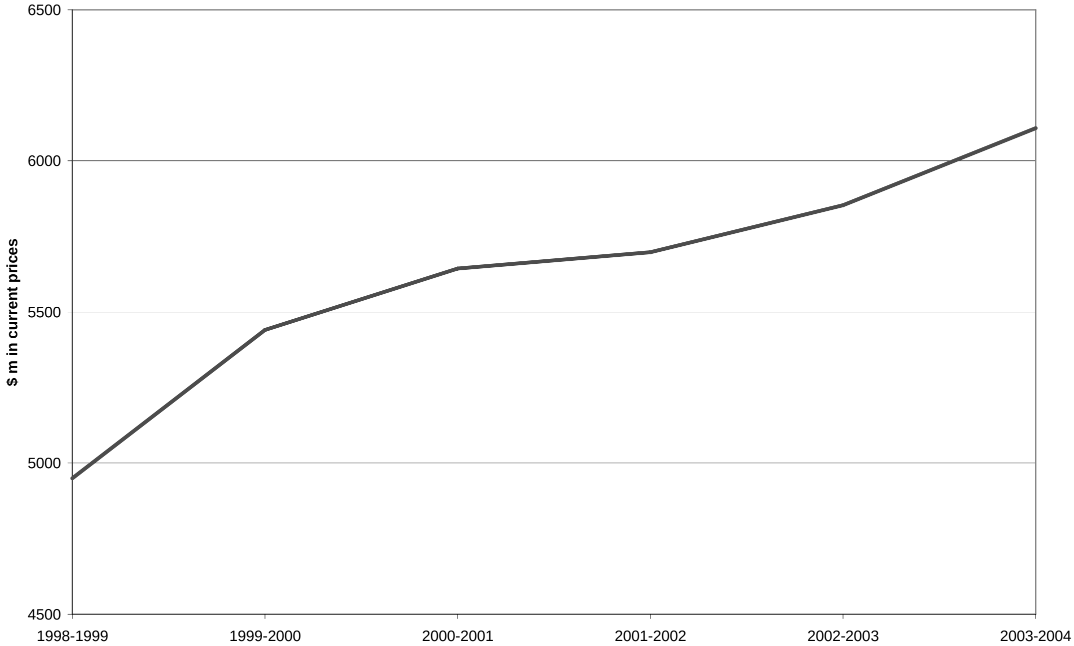
The current use of PAYGO for road access pricing had its genesis in the economic and regulatory reforms of the early 1990's that increased harmonisation of road transport regulation in Australia, through the work of the National Road Transport Commission.

The heavy vehicle pricing determinations using PAYGO have led to consistent registration charges in all States, Territories and the Commonwealth, avoiding the previous practice of transport operators registering vehicles in jurisdictions in which they could achieve the most favourable registration charges.

The application of PAYGO by the NTC and the resulting charges has the added benefit of being administratively simple to apply.

The Victorian Government has supported the application of PAYGO to road charges. PAYGO is a suitable charging methodology for a mature and well diversified network in which replacement or heavy maintenance expenditure is fairly even from one year to another and between blocks of years. As can be seen from Figure 1, road expenditure has been relatively smooth over the last 5 years. Consequently, the methodology underpinning PAYGO is suitable for developing road charges at the aggregate level.

Figure 1: Weighted Road Expenditure for PAYGO
All arterial roads, half local rural roads, and a quarter of local urban roads



Source: National Transport Commission

3.1.2 Features of the Current Road Pricing Regime

Cross-Subsidisation

The Victorian Government is aware that the averaging process that has been applied to the Heavy Vehicle Pricing Determinations has led to cross-subsidisation within classes of vehicles. That is, those vehicles travelling longer distances with heavier loads are subsidised by those vehicles travelling shorter distances with relatively lighter loads.

Given that the vehicles that carry higher than average mass and travel longer than average distances compete with long haul rail, the Victorian Government is, and has been, supportive of the development of mass distance charging.

The Victorian Government also notes that the aggregation and averaging of cost data leads to cross-subsidisation on the basis of location. This occurs because of the large differences in the numbers of heavy vehicles using different parts of the network. For example, location based charging would be likely to result in relatively lower unit prices for access to high volume routes like Melbourne to Sydney, as opposed to low use routes.

Cost Allocation and Recovery

The Victorian Government notes that current heavy vehicle pricing recovers the costs that have been allocated in the pricing determinations to heavy vehicles. However, both the road and rail industries have raised issues in regard to whether the level of costs currently allocated to heavy vehicles, and the range of costs included in the cost base, are appropriate.

The work of the NTC in developing the recently disapproved Third Heavy Vehicle Charging Determination resulted in some improvements in the cost allocation data and methodology in relation to, amongst other things, the relationship between heavy vehicles and road damage and the percentage of local road travel attributable to heavy vehicles.

Victoria believes that the Productivity Commission should examine the full cost of providing road and rail infrastructure and determine the appropriate cost base for developing road and rail charges. Victoria would also welcome the views of the Productivity Commission on the parameters for allocating costs to heavy vehicles and rail freight.

Pricing Relativities

The current pricing structure for road transport ensures that the registration charge for the lightest heavy vehicle (ie 4.5 tonnes gross vehicle mass)is not lower than that of the heaviest light vehicle. It is important to ensure that this element of the pricing structure is maintained to discourage a move towards lighter freight vehicles which, because of the greater number of vehicle trips required for a given freight task, results in more road wear and a range of externalities, such as decreased safety, congestion and greenhouse emissions.

Subsidy to B-doubles

In the Second Determination, the annual registration charge for a B-double prime mover was explicitly set at less than the amount needed to recover their costs, so that the charge on a B-double prime mover equalled the charge on a road train prime mover. This was done to discourage operators from shifting to less safe road trains or less efficient prime movers hauling single trailers.

The Australasian Railway Association (ARA), in its submission to the NTC on the Third Heavy Vehicle Pricing Determination, specifically raised concerns with the subsidy to B-doubles as these vehicles are generally considered to compete with rail.

Whilst the Third Determination would not have addressed all the issues relating to competitive neutrality of pricing between modes, it would have resulted in a reduction in the subsidy given to B-doubles from approximately $8,400 to approximately $5,500.

Annual Registration versus Flagfall

Due to the difficulty of developing location and time specific charging, heavy vehicle access pricing consists of an annual registration charge and a road user charge paid on diesel fuel of approximately 20 cents per litre. By contrast, rail access charges generally comprise of a flagfall and a mass-distance charge. The implication of this is that a heavy vehicle has a diminishing fixed cost per load whereas a freight rail user has a constant fixed cost per load. Victoria welcomes the views of the Productivity Commission about whether the different approaches to charging the fixed access components affects competition between modes.

Distortions in the Market

It is accepted that the approach used to develop heavy vehicle prices may have the potential to cause distortions within the marketplace and impede competition between and within modes. A key question that needs to be answered is whether the extent of any distortions within and between markets is so significant to warrant the adoption of an alternative pricing principle, as opposed to a further development of the PAYGO model. Alternative methodologies will need to be subject to a cost-benefit analysis.

In order to develop a cost-benefit analysis of any proposed changes to pricing, the Victorian Government is of the view that the Productivity Commission needs to determine the extent of contestability between road and rail freight and the extent to which the current charging methodologies distort the market both between modes and within modes.

In terms of contestability between modes, rail traditionally competes in areas of bulk long distance transport where rail can gain a critical mass. In Victoria, it has been observed that rail and road compete at the margin for freight travelling between regional areas and the Port of Melbourne.

Price is only one determinant of mode choice, with service factors also being a crucial determinant. Substantial investment is currently being made to address some service issues, particularly on the north-south route.

3.1.3 Heavy Vehicle Regulation in Victoria

In response to a specific query from the Productivity Commission on heavy vehicle regulation, Victoria does not allow road trains to operate within Victoria, except on short lengths of road that provide access to depots in the Mildura area. This exception has been made to facilitate freight movement, particularly grain, from New South Wales into Victoria.

Victoria has a single trial of B-triples underway under permit conditions. It is the operation of B-triples between the Geelong and Broadmeadows plants of the Ford Motor Company along duplicated highways.

B-doubles have general access to 99 percent of the Victorian arterial network.

3.2 Rail Pricing

3.2.1 The Victorian Essential Services Commission Approach to Rail Pricing

The Essential Services Commission (the Commission) is responsible for the approval of proposed rail access arrangements in Victoria. In 2005 a new Victorian Rail Access Regime (VRAR) was established and subsequently the *Rail Network Pricing Order 2005* (Pricing Order) was released. The Pricing Order contains a number of pricing principles and authorises the Commission to determine the methodology for calculating rail access prices. Any methodology established by the Commission must consider the requirements of the *Rail Corporations Act 1996* and be consistent with the Pricing Order.

In January 2006, following a period of consultation, the ESC released a *Rail Access Pricing Guideline* (Guideline) and in April 2006 *Victorian Rail Access Regime Proposed Rail Access Arrangements – Draft Decision* (Draft Decision). On 31 May 2006 the Commission made the Access Arrangement for VicTrack and made its Final Decision to reject the Pacific National and Connex proposed Access Arrangements. On 29 June 2006 it made Access Arrangements for Pacific National and Connex. The Final Decision and the Access Arrangements provide the Commission's position on its rail pricing methodology to date.

The Commission has established standing offer prices for all freight reference services. The Commission has defined freight reference services broadly, to include all services to standard types of freight trains, including currently operating trains, and all trains conforming to network standards. However, on the Pacific National country rail network reference services are also defined in terms of normal hours of operation.

Prices are calculated on the basis that a revenue cap is applied to the provision of all declared rail transport services (excluding terminal services). The revenue cap allows for the full recovery of efficient costs. The revenue cap features an 'unders and overs' adjustment mechanism and an efficiency carry-over mechanism. Other regulatory incentive mechanisms can be applied to the revenue cap, including a service quality standard adjustment mechanism and a cost pass-through mechanism.

The Commission has adopted the building block approach to calculate the efficient cost of supplying the regulated service. The building block approach is used extensively by Australian regulators. The Commission has adapted the building block model to suit the unique features of the VRAR.

In the Draft Decision, the Commission determined that indirect costs should be allocated between passenger and freight services based on the proportion of Train Kilometres (TK) for each as a proportion of the total TK. The Commission stated that the TK approach (as opposed to the Gross Tonne Kilometres approach) better reflects the relative costs of the passenger and freight services and is less likely to distort demand for rail services.

The Commission has also addressed price differentiation. For the Victorian country rail network, the Commission considers that prices for freight reference services should be geographically differentiated by two pricing zones the first comprising the Portland-Maroona zone and the second the remainder of the country network. They should also be differentiated between grain and general freight tasks. The Commission's analysis suggests that differentiating between freight tasks is likely to facilitate inter-modal competitiveness, while differentiating by geographical zone may result in prices that would be higher than the market bearable price on the freight-only lines.

The Commission has determined that when a multi-part tariff is applied, the fixed component should not exceed 30 per cent of the total charges and that the basis of the fixed charge must be on the length (kilometre) of the service. The Commission believes that a larger fixed component could deter efficient usage of the network and above rail competition.

The Commission's Decisions, and the Access Arrangements it has made, are available on the Commission's website (www.esc.vic.gov.au).

3.2.2 Rail - Other Impediments

The Terms of Reference refer to any other competition, regulatory and access constraints that could act as impediments to efficient pricing. The Victorian Government has received a number of representations concerning differences in pricing by terminal operators, access difficulties for third parties and freight handling technologies. The rail industry considers that these practices make rail-based supply chains less competitive. The views of the Productivity Commission on these issues would be welcome.

4. Externalities

The Victorian Government supports in principle the inclusion of externalities in road and rail charges for freight. This would be consistent with adopting a triple bottom line approach to pricing. Potential externalities include safety, congestion, health and emissions. However, there are a number of issues surrounding the practicality of externality charging that will need to be addressed.

There are very limited Australian data on a number of externalities, particularly environmental and health externalities. The National Project Appraisal Guidelines that were recently adopted by the States and Territories use a set of default values for some externalities. These values have been substantially drawn from overseas studies. The direct compatibility of overseas estimates with Australian conditions for a pricing purpose is questionable. The Victorian Government believes that Australian data should be collected and Australian based values developed for all externalities.

As the Productivity Commission points out in its Issues Paper, there are a number of externalities that are being addressed through other mechanisms, such as insurance premiums. In including externalities in the cost base, care needs to be taken to avoid double counting.

There are practical issues regarding the collection of externality charges that would need to be resolved. It would be possible to collect road externality charges as part of road access charges, however the private nature of rail means that a system for collecting externalities by Governments would need to be established, particularly where below rail operators are privately owned. One option for addressing the collection problem could be to collect the difference between externality costs in cases where road externalities are higher in aggregate than rail externalities. While this may be practical, it may not be an optimal solution as it does not represent full externality pricing. This option would require further investigation.

The current discount given to B-doubles recognises, amongst other things, the performance of B-doubles relative to other vehicles in terms of emissions and safety. Inclusion of externality pricing would more properly address these issues.

5. Timing of the Next Road Pricing Determination and the Need for Interim Measures

The Victorian Government notes that historically it has taken a number of years to develop a road pricing determination. For example, work on the recently disapproved Third Heavy Vehicle Pricing Determination commenced in 2002.

In developing a pricing methodology/principle, the Productivity Commission will need to ensure that the methodology is practical and that data are available to proceed to a determination in a relatively short time period. This is particularly important in light of the disapproval of the Third Heavy Vehicle Pricing Determination, as road prices are currently based on the Second Determination. The Second Determination uses data which predate the widespread adoption of B-doubles, particularly 9-axle B-doubles which compete with rail for heavy long-haul operations.

In the event that a new determination will take a number of years to prepare, Victoria encourages the Productivity Commission to consider a range of options for implementation in the interim period for consideration by COAG. In considering a range of options, the Productivity Commission should consider whether the Third Heavy Vehicle Pricing Determination represented a move towards more neutral road/rail pricing.

6. Conclusion

In conclusion, the Victorian Government supports the principle of efficient pricing of road and rail freight infrastructure where net benefits can be demonstrated and welcomes the Productivity Commission's inquiry. However, as stated in the Terms of Reference, any new pricing regime must maximise the net benefits to the community.

For the Inquiry to assist in the implementation of appropriate reforms, a key issue for the Productivity Commission is to consider the practical implementation options for any proposed reforms. In particular, the costs and benefits of alternative schemes and the distributional impacts of these costs and benefits (especially on remote and regional communities) requires consideration, as does the need for structural adjustment packages to offset any transitional impacts.

Financial incentives are also imperative to successful implementation of difficult reforms, as demonstrated through the NCP process. Ensuring that all parties commit to implementing reform in a timely fashion requires genuine commitment and support for nationally shared benefits. The Victorian Government awaits the Productivity Commission's recommendations on these matters.