NSW LAND TRANSPORT: COMPETITION POLICY AND ACCESS TO THE RAIL INFRASTRUCTURE

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COMPETITION POLICY AND ACCESS TO THE RAIL INFRASTRUCTURE

OVERVIEW

New South Wales (NSW) has the largest passenger and freight rail system in Australia. The dominant operator is the State Rail Authority (SRA), which is fully owned by the NSW Government. The Government also owns the State Transit Authority (STA) which operates public buses and ferries within the metropolitan areas of Sydney and Newcastle.

Reform of the transport industry is progressing on a number of fronts. Measures include assumption of regulatory responsibility for rail and passenger safety by the Department of Transport, provision of a commercial orientation for the SRA and STA, growth of new operators on the rail network (such as the National Rail Corporation), establishment of a community services obligations policy and creation of infrastructure access arrangements.

An important reform consideration is the recent competition policy decision of the Council of Australian Governments (COAG). The implementation of the national competition policy is a major challenge for all Australian public enterprises. Elements will include exposure to the requirements of the Trade Practices Act and the introduction of principles for competitive neutrality.

The decision will also require other operators to be provided with access to essential facilities (including rail infrastructure). Critical access issues include the terms and conditions on which access is granted. NSW experience is that developing policies and structures to support those principles is also relevant. For example, to retain coherence in overall rail policy directions consideration must be given to asset valuation, the expectations by Government as to the performance of its entities, and the accounting systems and data structures within rail authorities.

1. BACKGROUND

NSW POPULATION

NSW in the main is a sparsely settled area. Some 6 million persons live within its area of 800,000 square kilometres. However, within its borders the population is heavily concentrated around Sydney which with 3.7 million people is in international terms a large and sprawling city. A further 0.6 million persons live in the two other associated urban areas of Newcastle and Wollongong.

Beyond Newcastle and Wollongong some areas of the state, notably the north coast, enjoy rapid population growth - albeit from low bases. Demographers also comment on the increasing proportion of retirees moving to those areas.

These population factors present several challenges to the development of transport in NSW. They give rise to three distinct types of passenger transport issues; metropolitan, travel to or from Sydney to regional centres, and rural travel.

STRUCTURE OF PUBLIC PASSENGER TRANSPORT IN NSW

The public passenger transport industry in NSW can be segmented by modes. This modal segmentation is buttressed by modal specific involvement by Government in the forms of public authorities and regulations.

Rail transport is dominated by the SRA. The relevant passenger segments are urban passenger services, provided by the CityRail division, and rural and interstate services provided by the Countrylink division. In addition the SRA has a freight division in Freight Rail.

CityRail, by any international standards, is a large metropolitan rail carrier. In 1993-94 it carried 235 million passengers. Countrylink carried 2.3 million passengers for 850 million passenger kilometres.

Bus and ferry services are offered by the STA and by private operators. The STA operates bus and ferries in the Sydney and Newcastle metropolitan areas and in 1993-94 it carried 189 million passengers on buses and 14 million passengers on ferries.

Together the public transport authorities are especially important to the business functions of the city. Around 80 per cent of workers use public transport to get to the central business district.

Private bus services operate, under licence from the Department of Transport, in some parts of the Sydney metropolitan area, and regional centres. There are a limited number of private ferries in NSW.

It would be reasonable to say that there is still considerable room for improving the business operations of the SRA and STA. Recent reviews show there is scope for the authorities to progress to operate at world best practice standards; corporate planning,

benchmarking and reporting activities are directed at this end. Community service obligation contracts between the authorities and the Department of Transport will gradually improve the commercial focus. Also the transfer of safety regulation to the Department will allow the organisations to concentrate on operations within the regulatory environment rather than having a conflict of interest in being a self regulator. Such initiatives aim at changing the underlying focus of the organisations.

POLICY OF NEW NSW GOVERNMENT

A new Government came to office in NSW in March. It is a signatory to the April 1995 COAG National Competition Policy Agreement. Consistent with the requirements of that agreement the Government will be implementing some changes to arrangements for the SRA and STA.

SOME ISSUES

Externalities

It is important to recall the three typical types of NSW passenger journeys - travel within the Sydney metropolitan area, travel between Sydney and regional centres, and rural travel.

In Sydney a key issue is the impact of private vehicles on the quality of life. Sydney as a whole, like other large cities, suffers from the strong preference of people to use cars. The Industry Commission reported that cars have a modal share of 64 per cent compared with 13 per cent for public transport. The community bears external costs over and above those borne by motorists from this usage including costs of road accidents, congestion and pollution.

In economic terms, the presence of such externalities may mean that society would gain from a reduction in personal car use. To the extent that public transport provides a substitute for car use, this gives rise to an economic justification for government subsidy payments to public transport.

Mobility

Outside of Sydney car externalities are perceived to be much less of a problem. However, mobility - the need for some people to use a car to move from one place to another - is an issue. This need reflects an inability of public transport to cater for the demands of all possible passengers. This is also an issue in parts of Sydney. Low population densities render public transport services uncommercial; patronage is so diluted that public transport would be provided at a loss irrespective of fare levels. This gives rise to a social mobility argument for government involvement in public transport.

Distributional goals

The Government does, of course, set other goals for public transport. These include

assistance - an implicit redistribution of society's resources - to certain groups in the form of concessions (eg the unemployed, aged pensioners etc). Clearly there is some overlap between these goals and economic, mobility and distributional goals.

THE RESULTING GOVERNMENT INVOLVEMENT

Government payments for public transport in NSW are therefore directed to two goals - to lessen the external costs of the alternative arrangements modes (eg the car) and to promote social policy objectives. The community, through the NSW Government, devotes considerable resources to these goals (Table 1). Some 7.5 per cent of Budget expenditures goes to public transport and nearly half of this is in the form of transport concessions.

TABLE 1 NSW GOVERNMENT EXPENDITURE ON PUBLIC TRANSPORT

	1994-95 Budget A$ m	% of total
By transport operations		
. SRA	549.6 (1)	36.1
. STA	152.0	10.0
. Private	315.8	20.7
Total	1017.4	66.8
. SRA capital grants	505.6	33.2
Total including SRA capital	1523.0	100.0
By payment type		
General payment to SRA/STA (2)	173.4	13.6
Concessions for travel on		
. SRA/STA	285.6	22.5
. Private services	305.8	24.1
Total concessions	591.4	46.6
SRA capital	505.6	39.7
Total of above	1270.4	100.0
Compared with NSW Budget		
Public Transport	1523.0	7.5
Total Budget	20244.3	100

Notes:
(1) Includes payments to freight
(2) Includes payment to meet operating losses.
Source: New South Wales Budget Information 1994-95, Budget Paper No.2.

These budgetary allocations do not always include all the costs associated with the provision of public transport such as the full depreciation of assets, accrued unfunded liabilities, opportunity costs of providing infrastructure, and costs of collecting taxes to support the expenditures.

Monopolies

Most public transport services in NSW are provided by monopolies. Rail transport is provided by the SRA. The SRA holds a monopoly by virtue of ownership of rail track, and until recently, rights to use that track exclusively. Bus services are provided under exclusive franchises. These are awarded by the Department of Transport to the STA and to private operators.

There are certain conditions in transport and associated markets which lend themselves to a high degree of concentration and monopoly. That is a single firm may be the most efficient form of service provision. For example, there are large economies of scale and natural entry barriers to the rail transport industry. Rolling stock and maintenance facilities are a high capital cost. Moreover, only one organisation can own a certain stretch of rail track.

In addition, Governments impose direct barriers to entry to some markets. For example, exclusive area franchises for bus services. Also, Governments introduce indirect barriers to entry through funding arrangements. For example, it would be difficult for any operator to compete with the SRA when it is contracted to the government for the provision of community services.

2. NATIONAL COMPETITION POLICY

WHAT IS COMPETITION?

In the public transport sense, competition means that there is a possibility that one or all of several firms may provide a service to transport customers. The firms compete for customers.

Trade practice lawyers can attest to the fact that the presence of two or more firms in a single market does not necessarily mean that there is competition. Also, the fact that there is a single service provider does not mean that it faces no competitive pressure; there may be numerous firms willing to and who would enter eg. if prices increased, or if service quality fell.

A lot of the public debate about competition centres around the reduction in costs of

providing services. The hope, and a source of debate, is whether these cost reductions actually flow to consumers, or whether they are retained in the firm or siphoned off elsewhere.

However, from the public transport point of view, competition is wider than cost reductions. It is important to bear in mind customer perceptions of competition. To the customer, competition means choice. Simplistically, competition is good if it increases choice. A price fall is one mechanism for this - because the customer can buy more of the service (or other things). But there are also other mechanisms; eg. competition may be evidenced through additional or improved services.

Most discussion of competition within transport refers to **competition within markets.** The debate there is about which market structure, and what type of conduct within that market, can deliver to customers the most choice. The general presumption appears to be that the less regulated the market, the better will be the competition.

Again, it is useful to look at this from the customers' perspective. an this raises the key issue of "who are the customers?". First, and most obviously passengers are customers. Passengers pay fares and are provided with travel services. The general presumption appears directed at this case.

Second, and less obviously, Government (on behalf of the community) may be a customer. The NSW Government makes large community service payments to transport operators. In return, the Government, and the community, are provided with services which promote economic and social goals. In this respect the Government is also a customer, indeed a very big customer, of organisations like the SRA and STA. The general presumption needs careful interpretation here, as increased intervention in the market - price and quality regulation - may be desirable for social and *economic* reasons eg. price regulation via competitive benchmarking for a natural monopoly.

Competition may relate to operators competing for fare paying passengers as well as competing for government community service payments. Competition should be targeted at all aspects including service quality.

Third, customers can be either end users (passengers and governments as above) or producers - in the case of the sale of an intermediate good - like services used by rail operators; fuel, crewing, locomotives, wagons and rail access. The structure of competition in the markets of these intermediate inputs can have important effects on competition in the downstream markets eg. for passengers.

The downstream and upstream nature of many transport activities gives rise to consideration about the costs and benefits of vertical integration.

Economic theory points to certain cases where there are different types of results from certain structures. For example, in the case of a natural monopoly a single firm can deliver services at the lowest cost. But this may require vertical integration. Or firms may adopt "strategic behaviour" and not supply any services to a market until

competition within that market is limited. The problem is that attempts to create competition, by outlawing vertical integration or complete deregulation may result in less - not more - choice to the customers.

The nature of transport operations varies significantly across modes. For example, rail services have higher natural barriers to entry than bus services (eg the capital cost of a locomotive and carriages is substantially higher than the capital cost of a bus).

Also the nature of aggregate customer demands varies. For example among regions or "origin-destination" pairings. Passengers in one area may react more significantly to price changes, or to changes in service levels, than in another.

The optimal degree and type of competition can vary significantly according to these characteristics. The higher natural entry barriers in rail might justify less visible competition than buses. But there may be a greater need to consider alternatives like how to introduce competitive pressures among the providers of inputs to the rail industry in conjunction with competitive benchmarking.

The bottom line of these complications is that competition is not an end in itself and should not be introduced without firm consideration about the particular market and customers which would be affected - a "reality check".

Competition can be viewed as a process rather than an output. The process should seek to maximise choice available to end users - to passengers as customers, and to governments as customers.

COAG AGREEMENT

The Commonwealth and each Australian State Government agreed in April to implement a national competition policy. Relevant provisions of the agreement touch on almost every aspect of SRA and STA operations.

One major aspect is that there is to be a program of regulatory review out to the year 2000. Note that this ties in with the idea of a "reality check". If regulations are seen as the best method of providing a net benefit to the community then exemptions may be provided to maintain such regulatory structures. However, in general a principle will be that regulations should not restrict competition.

Public authorities like the SRA and the STA will be subject to the Trade Practices Act. Governments have agreed to put to their legislatures legislation which extends the Completion Code (including the Trade Practices Act) to all persons within their legislative competence.

The Trade Practices Act has provisions which seek to reduce anti-competitive behaviour in markets. Such behaviour might include price fixing, collusive activity, misuse of market power, exclusive dealing, and acquisitions that would result in a lessening of competition. It will be possible for Governments to seek public interest exemptions for some activities which would otherwise be held to be anti-competitive.

There is also an intention that public enterprises should face the same constraints and opportunities if they are to face competition from private firms - the competitive neutrality principle. Individual governments (like the program of regulatory reform) are free to determine their own agenda of applying competitive neutrality arrangements. This may involve tax equivalent payments, debt guarantee fees or just application of regulations that may apply to the private sector.

A further area touched by COAG is structural reform ie. the shape and role of organisations. It should be stressed (despite some of the publicity) that individual governments are free to determine their own agendas for the structural reform of organisations. Governments should consider the removal of regulatory responsibility from operating entities. This has basically been completed in NSW with the rail and passenger safety regulatory role being placed with the NSW Department of Transport.

Governments may consider the vertical integration issue; separating naturally monopolistic elements of an organisation from potentially competitive. An example would be the organisational separation of rail infrastructure from above rail operations. There is a need to have accounting separations in place as well as arrangements for access (to be discussed in the next section) but there is no requirement to structurally separate.

Governments may also consider the need for regulatory oversight of prices charged by monopolies. Already in NSW passenger service prices are reviewed by the Government Pricing Tribunal. The COAG agreement may provide scope beyond this - for example, to the oversight of intermediate input prices.

3. ACCESS TO THE RAIL INFRASTRUCTURE

COAG REQUIREMENTS FOR ACCESS

One of the most interesting parts of the COAG agreement regards access to essential facilities. COAG agreed that the Commonwealth will legislate to establish a regime for third party access to significant infrastructure facilities. The relevant facilities are those important to competition in other markets (ie. are intermediate inputs), would be difficult to replicate, and are of national significance.

The Commonwealth regime is generally not intended to cover a facility for which a state has in place an appropriate access regime. That is, if the state has an appropriate regime for access to certain infrastructure, then the Commonwealth regime would not apply. However, if the state does not have an appropriate regime, the intention is for the Commonwealth's regime to apply to essential facilities etc, virtually as a default.

Most states would intend to put in place there own regulatory regime for access. In NSW it is likely that the brief of the NSW Pricing Tribunal will be extended to cover access pricing to essential facilities.

The basic idea behind this aspect of the COAG agreement appears to be the enhancement of prospects for competition in markets dominated by a vertically integrated firm. The COAG agreement (wisely) was not definitive on the terms and conditions on which access is to be available; issues such as price, time and priority. However, it would seem that COAG's intention could only be effected fully if the terms and conditions faced by an outsider (ie. the non-owner of the infrastructure) would be roughly the same as those which the infrastructure owner would "place on itself" in the ordinary course of business. For example, if the infrastructure owner would charge itself $1 per hour to use the facility, the access charge to outsiders should also be in the region of $1 per hour.

Hence for the rail industry, whilst structural separation is not a necessary under the COAG decision, it is clear that there is a requirement for a clear accounting separation of infrastructure from above rail operations. This could be seen to be equivalent to the 1991 European Community directive. That directive requires accounting separation but structural separation is not necessary although Britain and Sweden have taken that approach.

NSW APPROACH ON RAIL ACCESS

The NSW approach is to establish an infrastructure unit within the SRA which is responsible for negotiating access to the infrastructure. The unit is required under the competition policy arrangements to consistently apply the access arrangements across all operators including internal operators. The unit will conform to the COAG Agreement eg. it will have separate accounts and deal among parties on a non-discriminatory basis.

This is a significant challenge as essentially there are only very general internal access arrangements in the SRA at present. The new approach will require the SRA to make significant improvements in cost and revenue identification and allocation, data capture and collection, negotiation and contract documentation, and accounting practices. These changes will need to be made in all major areas of the SRA; on SRA Corporate and on each of SRA's business divisions (CityRail, Freight Rail etc).

NSW has not chosen to have a separate infrastructure authority because in the end it is not expected that there will be many third party operators and forced separation may risk disaggregation penalties. There are economies of scale available from integrating rolling stock and rail track investment decisions.

It is certainly not expected that there will be multiple passenger operators competing on a single line in the urban area. However, this does not obviate the need to put in place access arrangements for the urban network. Basically all major freight movements in NSW are joint users of infrastructure with passenger services. One major freight operator, the National Rail Corporation, moves right through the CityRail network and will require a commercial access framework within months. It may eventually be the ability to pay access prices which will determine train priority between freight and passenger movements.

ACCESS PRICING

Considerable consideration has been given to a method for determining access prices. Similar thinking has been undertaken in other states and at the Commonwealth level. Initially some of those involved hoped for a fixed formula approach which could consistently be applied across operators and across the network. Such an approach was soon seen to be impracticable.

The rail network has a wide variance in profitability. Some lines are profitable whilst others require significant community service payments just to keep up maintenance let alone achieve a return on capital. The interconnectedness of lines - in a network - presents a real problem to the proponents of fixed formula pricing. A key difficulty with network pricing is the assignation of joint costs; fixed formulas tend to lead to usage and investment patterns which are inefficient in economic terms.

Without a fixed approach to pricing the alternative is commercial negotiation. The infrastructure unit will therefore have a commercial charter and will negotiate with all potential operators. If any particular operator considers themselves to have been discriminated against in the negotiations then they will have recourse to the regulator.

Consistent with the COAG Agreement, such negotiations will need to be within certain parameters. At a minimum the infrastructure unit will be required to recover its annual cash costs. For some of the marginal lines cash cost recovery will probably be the base position. Other lines will bring an above cash cost return on the assets.

A maximum has not been determined, although there is considerable economic literature on this point. Some of this refers to maximum prices as being set with reference to benchmarked costs, or on a CPI-x formula. The problems of price regulation which use these are foundations are well known and common to many industries.

However, some of the literature also refers to maximum prices being set with reference to asset values. The application of this is more problematic in the rail industry where the worth of assets is not always closely related to their values.

ASSET VALUATION

In economic and accounting terms prices (more precisely revenues) and asset valuation are linked. One way of measuring an asset's value is to look at its expected price (revenue) earning potential. Price regulators can view this as setting the asset's value at some arbitrary level (eg. depreciated replacement value) and limiting prices so that expected revenues equal that value.

For rail access this argument would run that access prices should be limited with reference to the depreciated replacement value of the infrastructure and corridor.

Unfortunately, in many cases, no access price could yield revenues at anywhere near such a point. The depreciated replacement value cannot be realised. Importantly in

rail there is no real option which would allow set asset values to drive access prices. In fact the reverse is more the case. If access revenue is insufficient, as determined by a negotiated approach, the asset values or target rate of return against those values may need to be reconsidered. Then the regulator's job is problematic.

In the case of the passenger system there is a risk that the significant government contributions may be allowed to feed a circular flow of cash that is sustaining higher than necessary asset values. We see little point in establishing a high rate of return on potentially high depreciated replacement values. Whilst some incentive for managers of infrastructure needs to be provided it is somewhat pointless to circulate government funding only to latter recoup the balance as dividends. It is worth noting that such an approach - artificial buttressing of asset values - may minimise track usage and limit the potential for competition on rail tracks.

Australian governments have produced a draft report on asset valuation for government trading enterprises. This report, which essentially advocates the use of depreciated replacement values, is currently being reconsidered in light of the possible impacts for enterprises like rail authorities.

There is increasing acceptance that there is a difference between say an electricity supplier which can essentially monopoly price and a rail authority which firstly has a wide variance in commerciality, secondly has businesses which are either marginally commercial or only profitable with the assistance of community service payments from governments, and thirdly provides broad competition - from society's point of view - to road transport.

4. SUMMARY

This paper has attempted to provide an overview of the arrangements for public passenger transport in NSW. Competition in our transport sector is not seen as an end but as a process which is considered on its merits for individual markets. There are a number of aspects of land transport sectors, particularly rail transport, which complicate the application of competition principles.

The recent COAG decision will bring major changes including the application of the Trade Practices Act to public transport authorities. Competitive neutrality issues are to be addressed and in the case of rail access an external market will need to be established for a service which essentially has never been provided explicitly in internal markets.

Access pricing for infrastructure will in NSW be a negotiated approach which is not driven off historical or replacement asset values. There will be a requirement for the application of these pricing arrangements to be able to withstand regulatory scrutiny by competition policy authorities. All in all an environment of significant change.

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