ACCC REGULATION, INDUSTRY STRUCTURE AND MARKET POWER CONFERENCE

Gold Coast

STRUCTURAL SEPARATION, MARKET POWER AND OPEN ACCESS IN RAIL

A PRACTICAL ASSESSMENT OF THE SUITABILITY OF THE NATIONAL ACCESS REGIME TO ADDRESS MARKET POWER AND STRUCTURAL SEPARATION ISSUES IN THE RAIL SECTOR

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1. INTRODUCTION AND OVERVIEW

For a long period the Australian rail industry was characterized by declining performance, a loss of freight traffic to other transport modes, a lack of above rail competition and innovation and inefficient below rail operations. Throughout the 1990's Australian governments adopted a number of measures to address these issues, including restructuring, corporatisation and privatization.

One measure on which particular reliance has been placed is the introduction of regulated open access to rail track. Open access regimes have been relied upon to address a number of important policy goals, including the regulation and control of monopoly pricing of access to rail track and the promotion of above rail competition.

Access regimes have also been promoted as the means by which we can achieve the best of both worlds, that is, the efficiencies that may derive from vertical integration and the benefits that flow from the promotion of above rail competition.

Today I would like to largely draw on my own practical experience in access regulation, not just in the rail sector but also in other infrastructure sectors. From that perspective, there appear to be a number of practical questions as to the suitability and effectiveness of open access regimes in meeting their policy objectives in the rail sector. In particular, open access regimes:

- do not appear to be well suited to deal with monopoly pricing concerns the rail sector; and

- appear to have great difficulty in delivering on the promise of timely and competitive access to facilities which are controlled by a vertically integrated operator.

Today there remains overwhelming reliance on open access regimes to address market power/competition issues in the rail sector. I acknowledge that economists, public policy and regulatory specialists are developing a more sophisticated understanding of the competition/market power issues in this sector. In this regard, I suggest that there is scope for them to give greater consideration to the practical limitations of open access regimes.

I will briefly review the history and operation of the national access regime and outline what I see to be these limitations.

2. NATIONAL ACCESS REGIME

The Australian national access regime is enshrined in Clause 6 of the Competition Principles Agreement and gains legislative force through Part IIIA of the *Trade Practices Act* 1974.

The national access regime:

- seeks to enhance economic efficiency by controlling the exercise of market power in nationally significant facilities (which I will call essential facilities for convenience) and, in particular, through the promotion of upstream/downstream competition; and

- is based on a negotiate/arbitrate model, whereby in the absence of commercial agreement of the terms and conditions of access, either the access seeker or the access provider may initiate the arbitration of the dispute by a third party.

It had its genesis in the Hilmer review of National Competition Policy. The Hilmer Committee noted that the owner of an essential facility had an interest in denying competitors in upstream and downstream markets access to that facility.

The Hilmer Committee considered that the general misuse of market power provision in the *Trade Practices Act* was insufficient to remove that incentive. It recommended that a national access regime apply to nationally significant facilities.

Importantly, the Hilmer Committee conceived of an access regime as a special power that would apply only to limited facilities and only in limited circumstances, relevantly, where access would promote upstream or downstream competition (reflecting the focus of its attention on competition concerns). The model proposed was to provide a resolution where commercial negotiations had broken down by way of an arbitration framework to resolve such disputes.

In doing so, however, the Committee did not necessarily envisage that the national access regime was to act as the framework for the regulation of essential facilities. A national access regime was only considered to be relevant when other structural arrangements could not be implemented. For example, it was stated that:

> "the preferred response to this concern is usually to ensure that natural monopoly elements are fully separated from potentially competitive elements through appropriate structural reforms: (p241).

In 1995 the Federal, State and Territory Governments agreed to the principles articulated in the Hilmer Report through the Competition Principles Agreement (**CPA**). The CPA imposed certain obligations on governments in relation to:

(a) prices oversight of Government Businesses;

(b) competitive neutrality between Government Businesses and their private sector counterparts;

(c) the structural reform of public monopolies;

(d) the removal of legislation that restricted competition; and

(e) access to services provided by means of significant infrastructure facilities.

The framework for the national access regime envisaged by the CPA was based on the negotiation-arbitration model recommended by the Hilmer Committee.

This model has since been incorporated into Part IIIA of the Trade Practices Act.

Part IIIA of the Trade Practices Act contemplates the provision of access to essential facilities in three ways:

(a) Through declaration of facility by the Minister following recommendation by the National Competition Council on the basis amongst other things that:

(i) access to the service would promote competition in at least one market apart from the market from the service; and

(ii) it would be uneconomical for anyone to develop another facility to provide the service.

The consequence of declaration is to invoke the arbitration powers of the Australian Competition and Consumer Commission (**ACCC**) in Part IIIA.

(b) By way of a state based access regime, which may or may not be certified effective. However, it is not certified there remains a residual risk of declaration. Whether a state based regime is effective or not is to be determined by reference to certain provisions of the CPA which reflect the negotiate/arbitrate model of access regulation.

(c) Through the provision by an access provider and the acceptance by the ACCC of an access undertaking. It is important to note that the ACCC in its guidelines on access undertakings explicitly contemplates that an access provider may adopt a model which is not an negotiate/arbitrate model. Although, as I note later the only rail access undertaking, the ARTC undertaking, is explicitly based on a right of arbitration.

It is worth noting that while the national access regime is built around a negotiate/arbitrate model, in practice special purpose regulatory frameworks have been established for critical infrastructure facilities in Australia. Most significantly, there is the National Gas Code and National Electricity

Code, which in substance involve ex ante determination of prices and terms and conditions and little real substantive role for arbitration of access disputes.

The airport sector was for a long time the subject of explicit prices surveillance, including a formal price cap regime before the removal of price regulation.

While the telecommunications sector, which has its own regime in Part XIC of the *Trade Practices Ac*t, formally adopts a negotiate/arbitrate model, in practice it has evolved to such an extent that we see the ACCC performing a role much more akin to a price regulatory role.

It is the rail sector in which the national access regime as conceived by Hilmer Committee and enshrined in the CPA predominates.

3. RAIL REFORM

The national access regime in some ways appears to have been in the right place at the right time for the rail industry.

In 1991 the Industry Commission reviewed the performance of the Australian rail industry. Amongst its recommendation were that:

- railways be fully corporatised;
- railway track owners allow other organisations to access rail networks; and
- above and below rail operations should be divided into separate business units, with separate accounts.

Through the 1990's each State Government and the Federal Government moved to introduce a commercial focus into the operations of their rail businesses, culminating in the privatization of all above rail operations in Australia with the exception of QR and the private operation of certain below rail operations as well.

The restructuring of the rail sector was shaped by a number of important economic considerations, including whether to vertically separate above and below rail track operations and the extent to which there was scope for competition in the above rail sector.

During this reform phase, while different structural/competition solutions were adopted, it is notable that there appears to have been almost universal acceptance that rail networks should be subject to open access.

In 1999 the Productivity Commission, in its report *Progress in Rail Reform*, concluded that the process of reform had transformed the structure and operation of Australia's railways through greater competition and more private sector participation.

However, it also noted that:

- most government owned railways are not viable – due to inter-modal competition and under investment and required significant government subsidies;

- greater commercial focus was needed, which was best achieved in part by new entry and increased investment and also contracting out, franchising or privatisation of government owned railways;

- different mixes of structural, access and ownership arrangements are required for different networks. In this regard, the Productivity Commission considered the following factors:

    - interface issues, which occur when there are competing demands for train schedules by trains from different networks, for example, freight trains traversing urban passenger networks;

    - the potential for rail competition:

        - 'for' the market – competition between bidders tendering to provide a given service; or

        - 'in' the market – competition between train operators for the same customers;

    - the extent of intermodal competition, particularly from road and shipping; and

    - the overall level of viability:

        - loss making – requiring continual government funding to either the track or train operations;

        - earning a reasonable rate of return that can support future investment and maintenance; or

        - achieving sustainable monopoly profits.

In relation to the last point, the Productivity Commission characterized rail networks into four categories with certain features and concluded that:

- The Interstate Freight Network was subject to strong inter-modal competition and should be vertically separated with an access regime approved by the ACCC;

- Regional Freight Networks generally had no market power and should be horizontally separated from other freight and passenger networks and be subject to a light handed access regime;

- Main coal networks did have market power and should be vertically integrated, with an operating franchise tendered on the basis of lowest freight rates and access incorporated into franchise agreements.

- Urban passenger networks should be horizontally separated, vertically integrated, there should be contracting out or franchising through competition for the lowest subsidies and access incorporated into franchise agreements.

In practice today, aside from urban passenger networks (and even there in some cases), competition and regulatory objectives are met through open access regimes.

4. A PRACTICAL ASSESSMENT OF THE SUITABILITY OF THE NATIONAL ACCESS REGIME TO ADDRESS MARKET POWER, STRUCTURAL SEPARATION ISSUES IN THE RAIL SECTOR

In that context, I would like to make a number of observations drawn from my experience on the suitability of the open access/arbitration regimes to address market power and competition issues in the rail industry.

4.1 Rail access is complex

While the rail sector relies most heavily on the traditional open access framework, there are a number of features of rail which suggest that this model may actually be less well suited to it and that rail access disputes are likely to be complex, difficult and time consuming to resolve. For example:

- a rail access service is likely to be less homogenous than the conveyance of an electricity, gas or a telecommunications signal;

- the costs of rail access are likely to vary more across different freight tasks and different components of a rail network, than in other industries;

- the conveyance of trains across a rail network is a more complex process to manage, requiring direct human intervention and monitoring, compared with other infrastructure industries which are largely governed by physicals;

- there is a much greater risk that a train will cause damage to a rail network and it is more difficult to control those risks, compared with other industries;

- there is a much greater risk that a deficiency in the network will jeopardize the item being conveyed (a train) than for other industries; and

- safety concerns are much more likely to involve a direct threat to human life.

Each of these elements is likely to complicate the resolution of access disputes through arbitration.

4.2 Rail network power may be limited

It is also notable that the circumstances in which rail networks may actually have market power and hence there is a risk of monopoly pricing are actually limited, particularly when compared to other infrastructure industries.

In particular, the existence of intermodal competition, downstream competition and also in many circumstances the sheer lack of demand for certain rail lines leads to the position that many networks are simply uneconomic from the point of view of covering their long run costs of operation and maintenance. In fact, it appears generally accepted that there are only relatively few rail networks which could engage in monopoly pricing.

It may be asked then, why do we have access regulation at all? I am not entirely sure why, but I can think of two reasons that people may advance. Firstly, where track is controlled by a vertically integrated operator, there appears to be a strong presumption that access regulation is required. Secondly, even where there is not, there remains a risk of declaration under Part IIIA such that the various States and private operators have considered it desirable to formulate access regimes/access undertakings so as to avoid the prospect of the general Part IIIA arbitration framework. In order to meet the effective access criteria, these regimes are then assessed against the default model in the CPA, which virtually requires the adoption of an access arbitration model.

4.3 The national access regime arbitration model will not necessarily work well in cases of monopoly pricing

Where a network does have market power, then there is likely to be a strong case for some form of price regulation. However, the open access/arbitration regimes do not necessarily work well in this situation and are likely to have very negative incentive effects.

The difficulties include the following:

- arbitrations are private and there may be limited scope to involve third parties and to seek their views;

- an arbitration is the resolution of the particular dispute and may not afford the ability to resolve broader regulatory issues of interest to other parties;

- an arbitration is binding on the parties and not other parties such that other parties may not be able to readily gain the benefit of the decision or may hold out the prospect of seeking arbitration to get a different outcome; and

- an arbitration between two parties precludes the development of more general regulatory solutions such as price caps or revenue caps, which may have advantages in terms of regulatory cost but also efficiency incentives.

There are a number of very significant negative incentive effects that flow from these characteristics, including:

- a reluctance to undertake capital investment in circumstances where there is a lack of certainty that capital expenditure will be recoverable through arbitrated outcomes;

- the inevitable focus in arbitration disputes on cost based pricing; and

- the inability to adopt incentive based regulation.

The response might be that it is of course open to governments through the development of their own access regimes or private parties through access undertakings to develop superior regulatory frameworks. There is truth in that response. But is not a complete response because such a regime must largely conform to the negotiate/arbitrate model if it is to conform with the criteria in the CPA.

Another response is that it is open to governments to develop pricing principles and pricing methodologies that minimize the costs of arbitration and provide greater degree of general guidance as to the outcome.

The difficulty with this is, in my experience, that the more detail and prescription that is legislated for in terms of pricing principles and pricing methodology, the less flexibility there is for the regulator to craft pricing frameworks which are adapted by experience to meet the needs of the industry.

The other point to note is that such pricing methodologies rarely turn out to be as easy or uncostly to apply as is first thought.

The final point would be that to the extent that it is possible to determine pricing principles and methodologies ex ante, then having them applied on a piecemeal case by case way may actually be the most costly way to regulate prices, compared to a general price review.

4.4 The residual role for arbitration in cases of vertical integration – there is no such thing as light handed access

The one area where the open access regimes appear to have an important role to play is in cases of above and below rail integration. This is the case not just in situations where there is potential competition in the market, but also where there is potential competition for the market.

I have touched on the arguments in support of vertical integration of rail networks. In some cases, for some networks, the case seems compelling - for example urban passenger networks. Ffor other networks, it seems less so.

It is also notable that urban passenger networks are least likely to face competition in the market and hence the costs in terms of loss of competition for such networks appear low. For other networks, even those which appear to be unviable, the prospect of competition seems more open, such that the costs of a loss of competition or potential competition are likely to be higher.

In this context, it is notable that where governments have retained a vertically integrated structure they have placed particularly strong reliance on access regimes to address competition concerns. But here where the need is potentially greatest, in my view the outcome is also likely to be disappointing and costly, principally for the reason that a vertically integrated operator is likely to have strong incentives to delay the resolution of disputes and to make the ultimate terms and conditions, including price, as unattractive for the access seeker as possible. This is of course understandable and there is nothing in fact wrong with an access provider properly defending its interests in the regulatory process.

In addition to the points noted above, there are a number of features of the open access arbitration model which facilities this:

- generally the lack of any backdating of decisions or the ability to make interim decisions creates incentives for delay;

- the procedural rules governing the determination of interpartes disputes and accordingly the number of intermediary decisions that a regulator must make which may be open to legal challenge;

- often, but not always, the lack of information available to the access seeker; and

- the difficulties of resolving confidentiality issues, particularly where both above and below rail information is required to be produced.

In short, in my experience the arbitration process is a costly and time consuming one.

It is also critical to note that the resolution of an access dispute through arbitration is unlikely to fully address the competition concerns that arise once the rail operator seeks to commence operations:

For example:

- the operation of rail networks and the control of rail operations on those networks involve a large degree of discretionary human intervention by the vertically integrated operator, in a way that is not the case in telecommunications, gas, electricity or even airports. The practical consequence is that there are many opportunities for a vertically integrated rail operator to undermine the quality of access actually received by an above rail competitor; and

- the very setting of the access price is likely to undermine competition, given that it forms a major variable input cost for the above rail competitor and is known by the vertically integrated rail operator. Further, to the extent that usage charges involve any degree of cost inflation, attribution of common costs or averaging, the vertically integrated rail operator will be well placed to undercut the above rail competitor.

Given these impediments, I would not be surprised to see a negative correlation between the number of access seekers on a network with the vertical integration of that network.

The typical policy response to this scenario is to enhance the arbitration regime, for example, to introduce strong powers of direction, information sharing and dissemination, back dating of

decisions and ring fencing. Interestingly, most of these reforms actually put pressure on the vertically integrated operator to begin to run its business along vertically separated lines. That is, the very policy response to concerns that an arbitration regime may not be sufficient to address concerns arising from vertical integration erode the gains said to be derived from vertical integration in the first place.

5. CONCLUSION

In conclusion, I suggest that open access regimes may not be that well suited to address market power issues in the rail industry, particularly in the context of vertically integrated operators, and that further careful thought should be given to this by governments and regulators.

In particular, I suggest that:

- open access regimes are not well suited to addressing monopoly pricing of access to rail track compared to other policy responses, including more straightforward price regulation models;

- open access regimes have limited capacity to promote above rail competition, particularly where there is vertical integration;

- there are likely to be substantial costs that arise from the loss of competition in above rail operations inherent to relying on open access regimes and the costs of the dispute resolution mechanisms; and

- attempts to address these concerns are likely to undermine the efficiency gains from vertical integration of above and below rail track operations.

My ultimate observations would be that:

- there may well be a tendency to overestimate the gains from vertical integration, particularly given the ability of vertically separated operators to achieve, through coordinated interaction with rail operators, many of the gains that may derive from vertical integration; and

- there may well be a tendency to adopt a static perspective and underestimate the prospects and significance of actual and potential above rail competition and the gains that may flow from that.