CORPORATISATION OF FREIGHT RAIL - A DYNAMIC EXAMPLE OF TRANSPORT REFORM

Gary Pedersen
General Manager, Finance & Strategy,
Freight Rail Corporation

ABSTRACT

On July 1 this year, the Freight Rail business group of the State Rail Authority of NSW, became Freight Rail Corporation, a statutory State owned corporation. Freight Rail Corporation provides perhaps the most recent and certainly one of the most significant examples of Australian governments' commitment to progress microeconomic reform

Freight Rail Corporation is a rail based freight transport company employing 4,000 people. It transports 65 million tonnes of freight in New South Wales, including export coal, export wheat, and other grains, minerals, containers and a range of general freight

Corporatisation was a logical step in Freight Rail's reform program and essential for it to be able to meet the challenge of competition brought about by initiatives under the National Competition Policy and open access to rail infrastructure in NSW.

The challenge for this new Freight Rail Corporation is to undertake a rapid transition to profitability in an environment where its most profitable business segment - coal is attracting the attention of other freight service suppliers. Freight Rail Corporation must secure its profitable business and reduce its operating costs to achieve its vision.

Contact Author

Gary Pedersen
General Manager, Finance & Strategy
Freight Rail Corporation
Level 12
126 Chruch Street
Parramatta NSW 2124
Australia

Ph : + 9843 9549
Fax: + 9843 9567

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INTRODUCTION

On July 1 this year, the Freight Rail business group of the State Rail Authority of NSW (SRA), became Freight Rail Corporation, a statutory state owned corporation Freight Rail Corporation provides perhaps the most recent and certainly one of the most significant examples of Australian governments' commitment to progress microeconomic reform

The corporatisation was enthusiastically welcomed by Freight Rail's management as we believe it provides an opportunity for Freight Rail to become Australia's leading freight transport company with:-

- highest quality service,
- best value operations, and
- the aggressive pursuit of business growth.

The corporatisation of Freight Rail had been on the agenda for some years but was only given the green light by the Premier of NSW in August 1995. This gave us under a year to undertake over 700 tasks which we had identified as essential to separate from the State Rail Authority and to begin a new life as a commercial business rather than a government service provider

I am pleased to have the opportunity to reflect on the last year's work and review the strengths and weaknesses of the approaches taken by the NSW central government agencies, the State Rail Authority and ourselves in building Freight Rail Corporation. I believe that our experience provides useful input for others embarking on similar exercises

In another meeting like this in two year's time it would be interesting to see if Freight Rail Corporation achieves the business targets it has set for itself and to assess the significance of our corporate structure in meeting these dimensions. Today rather than falling for the temptation of publicising the exciting future we see for ourselves I will be focussing on the corporatisation process which we have recently completed.

FREIGHT RAIL AND MICROECONOMIC REFORM

Freight Rail's corporatisation must be seen in the context of the wider program of micro-economic reform being undertaken in Australia. This microeconomic reform program is extraordinary in that it has the strong support of the two major political parties at both the Federal and State government levels. This is despite the fact that over the last 30 years elections have been largely fought over alternate economic philosophies.

Microeconomic reform has been a response to the pressure on governments throughout Australia, and the rest of the world to radically change the way they go about ensuring that their communities have access to the services required to enhance economic growth and community wellbeing. As part of this reform, Australian governments have accepted that their trading enterprises must increase efficiencies and offer much higher quality services to the community at lower costs

One of the most important aspects of the micro-economic reform agenda is competition policy

In 1991 the Commonwealth, States and Territories in Australia agreed to examine a national approach to competition policy In 1992 the National Competition Policy Review was established chaired by Professor Fred Hilmer

The Hilmer report was completed in 1993 It outlined a program for achieving a nationally competitive legal and pricing framework

The fundamental approach to the Hilmer Report proposals was to provide coordinated legislation subjecting the entire economy, both the public and private sectors to a competitive environment

Following consultations on the Hilmer Report a Competition Principles Agreement was signed by Australian governments and the Commonwealth passed the Competition Policy Reform Act. The agreement sets out the principles governments will follow in relation to oversighting prices, structural reform of public monopolies, review of anti-competitive legislation and regulations, access to services provided by means of essential facilities and elimination of net competitive advantages enjoyed by government businesses where they compete with the private sector.

The legislation establishes a legal regime to facilitate third party access to the services of certain essential facilities of national or NSW significance or related to interstate trade This is based on the view that access to certain facilities with natural monopoly characteristics is needed to encourage competition in related markets

The view on competition reform was that there was a long way to go and Government Trading Enterprises, including those providing rail services had been identified as being particularly in need of reform.

In 1994, in response to National Competition Policy, Rail Access was formed as a division of the State Rail Authority It was formed to facilitate access to the NSW rail infrastructure, in recognition that rail infrastructure was clearly an essential facility which should be open to competition.

In 1995 Freight Rail found itself in this environment with a new Government strongly committed to economic reform and to overhauling Government businesses to make them cost efficient and customer responsive by:-

- more rational pricing with charges more accurately reflecting costs,
- elimination of overstaffing and restrictive work practices, and

- increased exposure to private sector competition.

This new Government took office with a very clear agenda of:-

- consolidating the State's AAA credit rating,
- progressing microeconomic reform,
- meeting social justice obligations, and
- developing a world best environment policy.

Early in its life the Government announced a program of corporatisations and Freight Rail management was delighted to be included in this program. We took the view that corporatisation was a logical step in Freight Rail's reform program and essential for it to be able to meet the challenge of competition brought about by initiatives under the National Competition Policy and open access to rail infrastructure in NSW. The Government accepted that only through corporatisation could the financial discipline of the marketplace be brought to Freight Rail and allow it to achieve best practice and develop a success culture.

Freight Rail believed that its inclusion in the corporatisation program was in recognition of the important role it plays in the competitiveness of a number of significant NSW businesses and in the export performance of coal and grain - two of Australia's major foreign currency earners.

The success of microeconomic reform and associated corporatisation programs is still being tested throughout Australia and Freight Rail is very pleased to be at the "cutting edge". We are aware of the responsibilities of being a "test case" and will be looking to assist other organisations undergoing major reform and input our experience.

At Freight Rail Corporation we believe that we can now put in place the necessary reform to make Freight Rail Corporation a profit making, dividend producing business which will provide the highest quality service to customers and deliver the Government agenda through:-

- contributing to NSW's overall economic standing through its ongoing efficiency reforms and strong business growth,
- providing an example of successful microeconomic reform through its progress on corporatisation and the accompanying success culture,
- contributing to social responsibility through its agreement with the Government to provide services in a number of rural areas, and
- providing best practice environment policies and procedures.

FREIGHT RAIL CORPORATION

I would like to give you an understanding of the Freight Rail Corporation business

Before doing this I should make the observation that Freight Rail Corporation finds itself with strengths and weaknesses in the new competitive environment. The strengths flow from the fact that Freight Rail was a large, increasingly efficient train operator which had made significant reforms to its operations over the last 10 years. The weaknesses flow from the fact that Freight Rail Corporation carries the legacy of a number of inefficiencies which could not be eliminated while it was seen as a Government service deliverer rather than a commercial business

Freight Rail Corporation is a rail-based freight transportation business in New South Wales

Freight Rail Corporation employs approximately 4,000 people. It operates on a rail network covering over 7,000 kilometres. It transports over 65 million tonnes of freight in New South Wales, including export coal, export wheat and other grains, minerals, containers and a range of general freight. Its export coal operation is its most significant business accounting for over 60% of total freight tonnage hauled

The challenge for Freight Rail Corporation is to undertake a rapid transition to profitability in an environment where its most profitable business segment - coal is attracting the attention of other freight service suppliers. Freight Rail must secure its profitable business and reduce its operating costs to achieve its vision.

Business opportunities for Freight Rail Corporation arise from:-

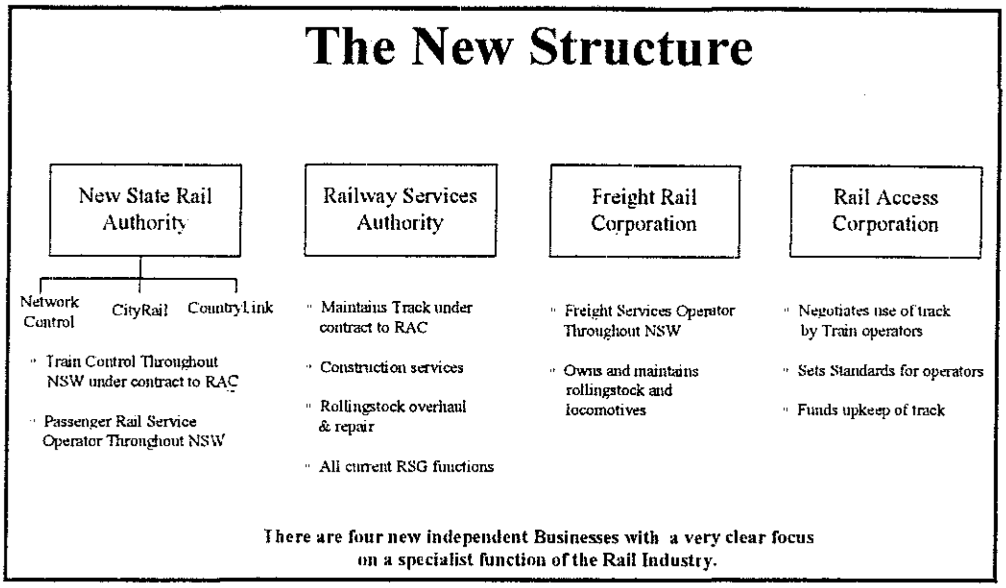
- an expected increase in the coal and minerals haulage tasks,
- an expansion in overseas demand for grain, and
- general freight opportunities

We are aware that these business opportunities can only be realised if we meet the challenge of significantly reducing our operating and overhead costs

RESTRUCTURE OF THE RAIL INDUSTRY IN NEW SOUTH WALES

The corporatisation of Freight Rail was to some extent more complex than the corporatisation of other government businesses as it was only one part of a larger restructure of the entire rail industry in New South Wales. Each of the 700 tasks, which had been identified, had to be separated into Freight Rail specific tasks before they could contribute to achieving corporatisation. This meant that we became involved in a complicated coordinating exercise which involved understanding other organisations' agendas as well as our own. These agendas were sometimes competing.

Railways in Australia have traditionally been structured as vertically integrated operators. That is the owner and manager of the infrastructure also is the prime transport operator. In NSW a decision was made to separate infrastructure from operations to enable other operators to run trains and allow for the benefits of competition.



The centrepiece of the restructure was the creation of an open access regime to be achieved by establishing the Rail Access Corporation. The Rail Access Corporation will advance competition policy initiatives and fulfil the commercial objective of maximising return on investment in infrastructure assets. Rail Access was also created as a statutory state owned corporation on 1 July 1996

Rail Access Corporation owns the infrastructure. It has opened the network to competition among train operators of which Freight Rail Corporation is one. The new State Rail will perform train control functions and operate passenger services. The Railway Services Authority will provide infrastructure maintenance under contract to the Rail Access Corporation. Railway Services Authority will also provide rollingstock maintenance services under contract to Freight Rail Corporation. These contracts, for both infrastructure and rollingstock maintenance, will be made contestable over a period of four years

Access charges have been developed to allow alternate operators and potential operators to purchase use of the network. Freight Rail Corporation negotiates its access charges with the Rail Access Corporation

Freight Rail Corporation's main concern with this restructure is the potential loss of communication between the business and the infrastructure maintainers. There is a real concern that the infrastructure managers and maintainers could proceed to maintain the infrastructure to a level which the business will not be able to afford. Freight Rail Corporation will maintain some infrastructure expertise to ensure it can communicate its asset management beliefs to the infrastructure owner. It will look to align itself with its customers in this debate.

This issue and the way we put forward our view became one of the most interesting problem areas for us as we corporatised.

THE CORPORATISATION PROCESS

Perhaps I should start here by talking about why I as General Manager Finance & Strategy took on the task of Project Director, Corporatisation I very quickly decided I wanted to be a key part of the corporatisation process and put myself forward to be the project director.

I had a small strategic project team which I could allocate almost full time to corporatisation tasks I also had carriage of the executive management committee which was able to double up as a Corporatisation Steering Committee This Committee is formed of all Freight Rail general managers and therefore has the capacity to give the highest level approval to proposals This is a different approach to other organisations which often set up Steering Committees with the various functional representatives allocated responsibility for team based projects

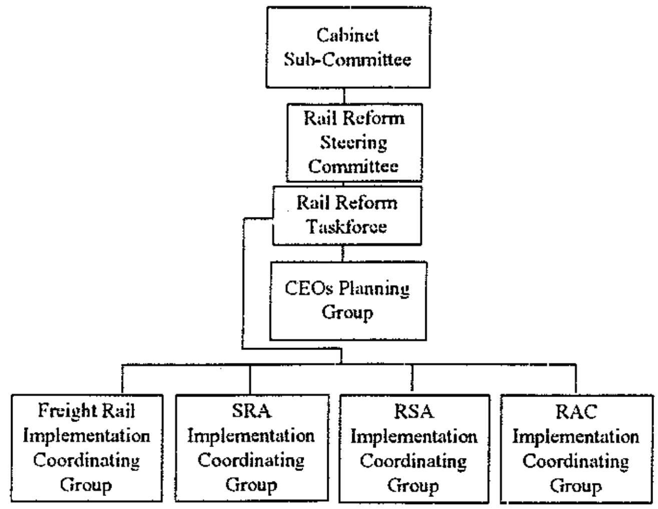
It was my view that we had no choice other than to have a tightly controlled process given the timeframe The process was accepted well by the other general managers and the organisation

The disadvantage in this process, which we did identify at the outset, was that we couldn't use the process of corporatisation itself as a change manager We were aware that other organisations had used project based teams not only to undertake specific corporatisation tasks but to communicate the "religion" of corporatisation and the changes it would bring Having said that our experience will give other organisations an alternate process.

It is important to understand the way the central agencies in NSW decided to undertake the rail restructure and the associated corporatisations.

The NSW Government established an interagency committee structure to implement rail reform and corporatisation tasks across all rail entities.

Rail Reform Structure



This interagency committee structure reported direct to a sub committee of the NSW Cabinet at which level broad policy directions were set.

Adding to this structure was the involvement of the rail unions at all levels. A correspondingly complex meeting structure was established to ensure the unions were involved throughout the process.

The structure meant there were an extraordinary number of meetings to attend and briefing notes to prepare.

In the final outcome, the majority of corporatisation tasks, aside from drafting the legislation, were undertaken internally by Freight Rail. And we preferred it this way.

Freight Rail developed a comprehensive program to progress change in a range of areas, including:

- commercial management - asset and liability valuation, taxation and corporate planning,
- legal and regulation matters,
- corporate governance, including structural issues and determination of appropriate Board arrangements,
- industrial relations and human resources,
- general administration,
- systems development and modification, and,
- communications with staff, unions, customers, suppliers, Government, special interest groups and the general public

When the program started there was an anxiety that tasks were being carried out in isolation and wouldn't fit together This was despite the fact that we had weekly meetings and an update of the program after these meetings Around about the middle of May, six weeks before the target date, I'm delighted to report that we could see the picture coming together albeit with some gaps here and there

I'm obviously not going to go into each and every task that we undertook but I do want to spend some time on the key tasks There were generic corporatisation tasks such as:-

- "due diligence",
- corporate governance,
- negotiating the Statement of Corporate Intent with Treasury,
- communications,
- setting up the legal framework, and
- risk management

Other tasks which I'll also refer to encountered problems specific to our corporatisation, involving as it did, a split from a much larger structure These are ones however which are likely to be experienced in other transport reforms and therefore worth mentioning:-

- negotiation of inter - entity service agreements,
- separation of information systems, and
- development of a corporate financial model and negotiation of access charges

Due Diligence

At first we approached due diligence with a great deal of suspicion, as we didn't know what it meant - and it seemed to mean different things to different lawyers!

Once we defined due diligence, we embarked on a due diligence process We set out to satisfy ourselves, that is the project team, that if we were purchasing Freight Rail Corporation we wouldn't be in for any surprises We found that our 700 task project plan did produce a corporation

In order to bring objectivity, the due diligence was set up as an "acquisition due diligence" with a Due Diligence Taskforce The Taskforce acted as the purchaser under the direction of the Chairman and Managing Director who formed the interim Board of the newly corporatised entity

The Taskforce was assisted by external advisers In particular a legal firm was retained to provide advice throughout the process This firm worked very closely with the Taskforce and assisted in interviewing all key players in the corporatisation process to ensure progress was satisfactory and that there were no gaps This worked extremely well, with the legal advice being invaluable

The that were examined in considerable detail included:-

- Corporate Governance Issues,
- Assets and Liabilities,
- Contracts - including general customer and supply contracts, Rail Access Contract and new contracts with Rail Entities
- Necessary staff to achieve objectives of the organisation,
- Management Structures, including risk management, policies and procedures and business planning,
- Finance and Accounting Structures, including financial benchmarks, asset management and taxation,
- Financial, Maintenance and Human Resource Systems, and
- Legal Compliance Structure, including compliance with relevant legislation, necessary operating and statutory licences for operation, trade practices, health and safety, rail safety and environmental compliance

Corporate Governance

The legislation establishing Freight Rail Corporation, provided for a Board, two shareholding Ministers and one portfolio Minister. In general, the Portfolio Minister has regulatory responsibility for rail businesses in NSW. The Voting Shareholders have responsibility for the commercial operation of the Corporation and the Board is accountable to the voting shareholders The legislation is clear about the roles of these, however, it will be interesting to look back after two years and see how it worked in reality.

As part of corporatisation, we undertook a project to develop advice on:-

- the relationship between the Board, the shareholders, the managing director and officers,
- existing and proposed control and internal reporting procedures to ensure they were satisfactory and reliable,
- the responsibility and accountability of line management and staff, and
- those management information systems required to monitor controls and provide realistic, timely and up to date assessments of Freight Rail Corporation's position and results.

Statement of Corporate Intent

Freight Rail Corporation developed a Statement of Corporate Intent which is its contract for commercial performance with its shareholder, the NSW Government. The Statement covers its:-

- core business which was agreed by the executive management committee,
- objectives as set out in the legislation,
- accounting policies,
- pricing policies,

- financial benchmarks, targets and planning,
- capital program,
- asset and liability management,
- risk management, and
- corporate plan.

Communications

Freight Rail's biggest area of concern throughout the corporatisation process was staff communication. Freight Rail saw corporatisation as a vehicle to change the culture of the organisation through a program of full communication. This was not able to happen in any significant way for a variety of reasons

This was, in my view, the one part of corporatisation where we very nearly failed. Communication with staff started too late. However, when it did start it started in earnest and we set about distributing as much information as we could. The unions however had to sign off each communication sent to staff which slowed the process down considerably. The communication process included:-

- communication forums around the State led by the Managing Director. These forums reached around 1,000 staff or 25%,
- regular corporatisation newsletters, and
- a corporatisation "hotline" - both phone and fax.

Communication was also initiated with customers and included:-

- individual visits by the appropriate marketing staff, and
- a package of information outlining the changes and how they would affect them.

Suppliers and contractors were also sent letters outlining the changes.

Legal Framework

Much of the legal framework was undertaken by The Cabinet Office - that is - the drafting of the legislation and the memorandum and articles of association. Freight Rail was given the opportunity to comment on the drafts of each of these and the lawyer who assisted with due diligence coordinated this.

Risk Management

Freight Rail engaged a risk management firm to conduct a detailed risk analysis of Freight Rail. This was a key part of the due diligence program. The risk analysis:-

- identified the risks to which the Corporation would be exposed,
- developed a range of responses for dealing with these risks, including the purchase of insurance and a process of due diligence documentation and reporting, and
- developed a risk management plan for Freight Rail Corporation

Inter Entity Service Agreements

Inter entity service agreements included those agreements which had to be negotiated between the different rail entities for service provision. This included a wide range of activities, from freight employees selling passenger rail tickets in rural locations to the previously Corporate Human Resources department providing a whole range of services to Freight Rail Corporation. This area proved to be very difficult for a number of reasons:-

- managers had little or no experience in pricing their services,
- there was a reluctance to include performance measures in the service contracts,
- Corporate SRA in some cases wanted to continue to provide services rather than devolve functions to enable their staff levels to remain constant, and
- the rail unions had an interest in keeping service provision within SRA Corporate as they saw this to be in the staff's best interests.

Information Systems

SRA was structured around a set of outdated, centralised information systems. Several years ago, SRA decided to implement a new set of systems which were to be integrated but still on a centralised basis. When the rail restructure was announced this approach had to be changed, and the systems had to be implemented separately for each new rail entity. This was the one area which could mean Freight Rail Corporation would not successfully corporatise as the systems included payroll, accounts receivable and accounts payable, general ledger, fixed assets, supply and maintenance.

Financial Model and Access Charges

Freight Rail Corporation was to be structured financially so that it could operate successfully in the competitive environment. A financial advising firm was engaged by NSW Treasury to recommend capital structures for each of the four new rail entities. The methodology for the study would ensure Freight Rail Corporation's capital structure would allow sufficient flexibility for the business to cope with the risks inherent in the competitive environment. The methodology is based on cash flow analysis and requires that the level of debt satisfies conditions:-

- maintain a good investment grade rating over the next five years,
- finance the approved capital expenditure program,
- debt be capable of being repaid within a reasonable period,
- sufficient flexibility for reasonable contingencies,
- satisfactory levels of liquidity be maintained, and
- sustain levels of required financial distributions.

Financial projections and opening balance sheet were to be formulated on the basis of the recommendations from the study

The complicating factor here was that into June this study was still not completed. One of the major factors delaying the study was the fact that access charges had not been negotiated. The lack of agreement on access charges and the implications of this was probably the single biggest concern in the whole corporatisation process. As access charges were likely to form up to 25% of Freight Rail Corporation's expenditure, without them, there could be no agreement on capital structure, community service obligations or the statement of corporate intent.

ISSUES ARISING DURING THE CORPORATISATION PROCESS

The biggest constraint factor in Freight Rail's corporatisation was the time. Our assessment was that to undertake the program they way we would have liked, we would have needed two years. The time factor resulted in a number of compromises being made

Existing SRA policies and procedures had to be adopted in many of the crucial areas of finance and human resources. While we have always stated our intention is to review these to ensure that they allow the business to be competitive, simply having them there sends the wrong messages, that is, that we're not different - we still have the policies and procedures of a service provider, not a business. We will counter this problem by using the review of policies and procedures which will be undertaken as a priority over the next twelve months as part of the change management process

As stated earlier and related to the above, we had to contract with the SRA for provision of far more services than we originally intended. This was particularly so in the human resources area. This also causes the most problems as human resources is the area most visible to all staff, and there will be little change in the first year. SRA has traditionally been poor in providing human resource services to the various business groups. This represents a significant challenge for Freight Rail and Corporate SRA to change the culture to Corporate SRA providing best practice human resource services to its customer, Freight Rail Corporation.

When it was decided to restructure the implementation of the new information systems, it was already almost too late as there was only six months to complete implementation of a full set of integrated information systems in the areas of:-

- financial - general ledger, fixed assets, capital works, accounts receivable and accounts payable,
- human resources - establishments and payroll,
- supply, and
- maintenance

This meant that instead of implementing systems designed specifically for Freight Rail Corporation's requirements, compromises on functionality were made. These will need to be refined over the next twelve months to ensure best practice information systems.

The next most significant problem, aside from time, was the ownership and acceptance of corporatisation by Freight Rail and SRA staff. Restructures in some way have been occurring since 1989. When the current restructure was announced there was a feeling it would never really happen or that it would be like the eclipse of the moon - here on 1 July and not to be seen for many years hence. The view was that governments come and go but the railways had been around for 140 years and would still be here in another 100 years.

We had hoped that a concerted effort at staff communication would solve this problem, however, as stated earlier, we were restricted in the level of communication we could initiate with our staff.

Through the whole process of corporatisation, Freight Rail was still a division of the SRA. The Freight Rail CEO and the SRA CEO were one and the same person. This became a problem as Freight Rail sometimes saw itself as having a different agenda to the SRA. There was an element of SRA management which took a view that corporatisation was a "restructure" rather than an entirely new game. The practical effect of this was to delay some important tasks, for example, a Freight Rail specific risk assessment which was crucial to due diligence. This had to be done in one month rather then the six it should have taken.

A problem running through the whole process was that Freight Rail, for the last seven years had been a business group of the SRA, never in charge of its own destiny and with no voice in the policy setting arenas of government. Our lack of what we call strategic position, had a significant effect on our whole corporatisation push. Information on our business was sought not from us directly but from others. Assumptions were made about the effect of certain activities which were erroneous.

Initially, Freight Rail believed that separating the infrastructure from the rail operations was not necessarily the best way of achieving competition in the rail industry. While we had legitimate concerns about this, which we documented and discussed, we weren't listened to. At the high policy level we were simply seen as "protecting our turf". I must say this was not the case, in fact I was impressed by the way even the most conservative engineers in Freight Rail accepted the separation decision when it was made and got on with putting in place the best processes to make it work. They even came up with reasons as to why the decision would lead to better service delivery and a more focussed Freight Rail Corporation. Because we had actually taken on this debate, it took us some time to get into the corporatisation debate. When we did, we appreciated the respect and understanding of the positions we put forward, in particular, we were assisted in getting our views across by the NSW Premier's Department representative on the rail reform taskforce who had been seconded from the United Kingdom.

FUTURE CHALLENGES

Significant benefits have already been seen from corporatisation. Freight Rail Corporation is in charge of its destiny and has the ability to make decisions in Freight Rail Corporation's best interests We have a strong commitment to input into policy decisions at all levels of government and see ourselves becoming a key player in the development of policies, programs and projects influencing the freight industry Freight Rail Corporation believes it must be proactive and input information and views which ensure decisions are made and a business environment developed which favours Freight Rail Corporation's corporate goals.

One of the most challenging issues to resolve, now Freight Rail Corporation has begun operation, will be the relationship between Freight Rail Corporation's Managing Director, Board, its Portfolio Minister and its Voting Shareholders Freight Rail is subject to the direction of the Minister for Transport (Portfolio Minister) on public interest issues The Minister must consult with the Board and have the agreement of the Treasurer before issuing a direction If any directions from the Portfolio Minister are deemed by the Board to be non commercial Freight Rail Corporation is entitled to be reimbursed for any financial loss This arrangement is enshrined in legislation How this division of responsibilities will be managed in practice and indeed in Parliament has yet to be tested

Freight Rail Corporation for the first time will be working with a full Board focussed solely on freight transport issues The directors will set Freight Rail Corporation commercial targets and expect the business to match the best commercial results.

Perhaps the most exciting and certainly the most difficult challenge will be developing a success culture through building teamwork, changing policies and processes This involves managers having trust in employees and devolving decision making to staff This too will enable Freight Rail Corporation to inject flexibility into its operations

Freight Rail Corporation knows it will have to improve its customer service to survive in the new competitive environment. We don't underestimate the size and complexity of this task. It will also be crucial that Freight Rail Corporation understands its business and uses benchmarking as a tool to assist in process improvement Benchmarking has in the past been used to some extent as a political tool to show inefficiencies and justify rail restructure In the future it will be used to improve all aspects of the business as Freight Rail Corporation moves towards its vision.

CONCLUSION

Looking back there were strengths and weaknesses in Freight Rail Corporation's corporatisation. In the end the time constraint became a strength in that tasks simply had to be completed and given the highest priority by everyone in the organisation. The weaknesses of the process came about through the complicated high level central agency decision making apparatus This meant that our corporatisation was a rail restructure issue rather than a business development issue

I'd like to say that this has been the most interesting period in my career. The reform of Freight Rail was critical for success in an environment characterised by open access and competition. It allowed Freight Rail management to demonstrate the organisation's ability to provide the best freight transport service possible

I would very much like to return to a group like this in two years time and report back on our progress.

We intend that we will be looked at as a real success story in microeconomic reform

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