

# AWB Response to the Review of the Western Australian Railways (Access) Code (2000)

This purpose of this submission is to comment on the recent review by the ERA of the Western Australian Railways (Access) Code (2000) “the Code”<sup>1</sup>

The purpose of the ERA’s review is “*to assess the suitability of the provisions of the Code to give effect to the Competition Principles Agreement in respect of railways to which the Code applies*”<sup>2</sup>.

AWB believes that the Code has failed to meet the broad objectives of the Competition Principles Agreement and that this is evidenced by the absence of entry since the Code became effective. This paper comments on areas where AWB feels that the Code is unsuitable, and some, but not all of the comments are drawn from previous submissions made by AWB on the key regulatory instruments established by the Code.

## Key Points

- AWB, a major grain exporter and a major railway customer in Western Australia, has a strong interest in efficient railway services.
- AWB has found (in NSW and Victoria) that access by a competitor railway helps achieve lower freight rates and better service from the incumbent railway. Such access has not been achieved in Western Australia, despite the provisions of the Access Code and its supporting documents.
- The immediate problem appears to be in the pricing rules. The gap between the floor and the ceiling is large and provides little real guidance. The economics of grain lines are such that the price should be at or near the price floor. Instead AWB was quoted a figure that equates to approximately 2.7 c/ntk - substantially greater than the number it was expecting, based on its experience in other regions. An access fee of 2.7c/ntk is uneconomic for grain freight.
- A consequence is that access applications, if pursued, become disputes – which can drag on and incur transaction costs (of management time, lawyers etc) that are high compared with the amount of business in question (eg one or two competing grain trains, as AWB has achieved on the East Coast). This deters attempts to gain entry.
- Effective entry for grain trains has been readily achieved on the vertically separated tracks in NSW and Victoria (ARTC interstate line). Obtaining access there, at reasonable prices, is not difficult. If the infrastructure/railway separation arrangements in WA were effective, access would also be achieved there. It has not, confirming AWB’s earlier concerns about the arrangements.

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<sup>1</sup> Following a request from the ERA to exclude certain confidential matters, AWB has amended this document to allow it to be made available for public comment.

<sup>2</sup> Railways (Access) Act 1998, Section 12.

- Instead AWB considers that the modest rate reduction that has been achieved is the result of improved road competition, not potential rail competition. And the reduction is small compared with the efficiency gains that have been achieved, and with what AWB achieved with a competitive railway in the East.
- AWB is also concerned that the regime, by deterring access and thus protecting monopoly revenue, could be protecting a network that is not optimum. As a network review is currently under way, it is premature to reach conclusions on the access regime.
- AWB also considers the penalties too low compared with what it at stake. The protective effect of entry deterrence need only amount to 0.11% of WA grain haulage revenue to outweigh the possible fine.

## 1.1 Background

AWB is Australia's statutory wheat marketer making it this country's major national grain marketing organisation and one of the world's largest wheat management and marketing companies. In addition to grain trading, AWB provides finance and risk management services to growers and manages Australia's national wheat pools, which account for around 3% of the total value of Australia's exports and approximately 12% of Australia's total farm exports. Furthermore, AWB is actively involved in a number of other areas of the grain value chain including grain storage and distribution (Victoria & NSW), port operations (Victoria) and train resource management (Vic & NSW).

There are over 7,500 grain growers throughout Western Australia who produce an average 10+ million tonnes of grain per annum. Approximately 95% of the State's grain production is destined for export markets, with the balance to domestic consumption. Grain has been transported through the State's rail network for over 75 years, which continues to be integral part of the grain supply chain in Western Australia.

Western Australia is made up of four export zones, being Geraldton, Kwinana, Albany and Esperance all of which are serviced, at least in part, by the rail network. Grain transport on rail represents nearly 30% of the total freight volume on the rail network, covers over 3,600kms of track, serviced both on the Standard and Narrow Gauge rail lines.

Continued efficiencies in farming practices, agronomic improvements and the increased percentage of cropping on available farmland have seen annual grain harvest production sharply increase over the past 25 years. Harvest production, which greatly depends upon the seasonal weather patterns ranges from 7 million to 12 million tonnes, with industry projecting future growth to 15+ million tonnes within the next 3-5 years.

In a typical year the export rail task represents over 65% of the total harvest production, depending on grain production distribution patterns and export zones. The remainder of the harvest production is carried by road to ports or local customers. The export rail task is a daily transport operation, which covers a twelve month period.

CBH are the storage and handling service provider for AWB. The CBH grain storage network comprises 197 receival points (including the four export terminals), of which 158 sites are serviced under the current rail contract. Of the 158 sites, 127 are direct rail serviced receival points and 31 are road-serviced points, which feed into rail. The rail system regularly delivers grain tonnages of over 200,000 tonnes per week to meet our export commitments. Significant investment in infrastructure throughout the grain growing zones and export terminals has been undertaken with the aim to further improve performance of the rail network.

## **1.2 The Objective of the Act and the Effectiveness of the Code**

The stated objective of the rail access regime as specified in the Railways (Access) Act 1998 “the Act” is to encourage *“the efficient use of, and investment in, railway facilities by facilitating a contestable market for rail operations”*.

AWB believes that the most effective tool for creating and passing on efficiency savings is a competitive marketplace, and feels that the absence of any significant new entrants to the Western Australian marketplace indicates that the Code does not sufficiently promote competition in line with the objectives of the Act. AWB feels that the Code needs to be revised to end vertical integration in the Western Australian rail infrastructure, or to reinforce the virtual separation of the entities, which it feels has not been achieved with any degree of success.

AWB would also like to note that the Act does not define “railway facilities”, and would strongly urge that these facilities include sidings and other facilities essential for access to the network.

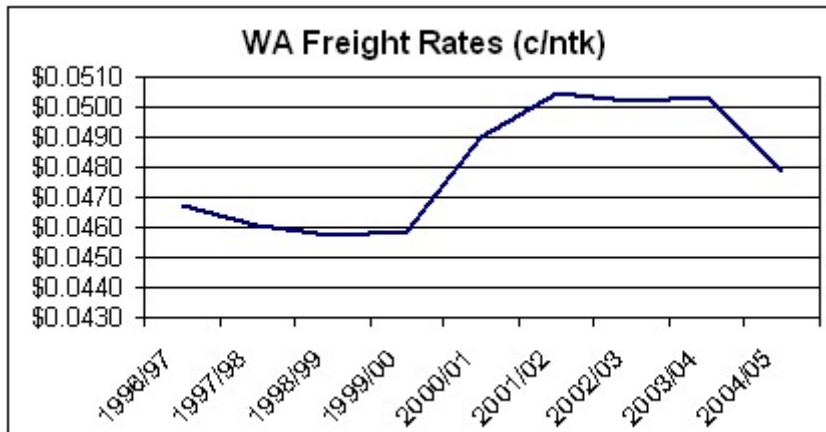
### **1.2.1 AWB’s Experience with Effective Rail Access Regimes**

Rail freight is an essential input to transporting grain between country areas and (a) ports and (b) some domestic users. Road freight is generally not an effective competitor for grain freight over longer distances – in Western Australia, the average distance over which export wheat is by rail transported is 288 kilometres. Rail transport is also generally more efficient with quantities of 1000 tonnes and more – a quantity normally achieved for export movements and a minority of domestic movements.

#### **Impact on Freight Rates**

AWB’s prior experience of the introduction of open access to rail networks indicates that open access results in significant freight cost savings for growers. For example, the Dimboola grain facility operated by AWB on the interstate rail track operated by ARTC, which commenced operation in November 1999, has resulted in significant rail freight rate reductions because of the effectiveness of the ARTC’s access arrangements. A substantial portion of this freight saving is due to the ability of competing rail freight operators to access the rail lines connecting the Dimboola facility to Melbourne. Significant rail freight reductions have resulted from the introduction in 2000 of two new rail freight operators on the New South Wales intrastate network to compete with the incumbent. Freight rates offered by the two new entrants represented sizeable reductions on previously existing rates, and in response freight rates offered by the incumbent also fell. In both cases, freight benefits of the order of 20% - 25% were attained for grain growers compared to the previous season.

Figure 1: WA freight rates



During the period from 1999-2005 rail freight rates in Western Australia have actually increased by approximately 4.3%, as shown in above. AWB contends that productivity gains (and hence reduced freight costs) would be more evident if AWR were faced with a genuine presence of above rail competition.

### Effective Open Rail Access and Road Transport

As demonstrated above, where a rail access regime has allowed above rail competition, rail prices have significantly decreased. The reduction in transport costs appears to have also improved rail's market share for grain haulage. Whilst it is difficult to make comparison between seasons, there appears to be strong evidence that more grain is now being delivered to silos where above rail competition exists, at the expense of nearby silos that have only road access. In effect, the rail access regime has created an environment that generates additional tonnes on rail and reduces the need for road transport. There appears no reason why a similar result would not eventuate if above rail competition occurs in Western Australia.

#### 1.2.2 Expected Impact of an Effective Rail Access Regime in Western Australia

Based on the above evidence and assuming a conservative 15% reduction in freight rates from the introduction of competing rail freight operators in Western Australia using an *effective* access regime, transport savings of \$2 per tonne would result. AWB estimates that this would represent a benefit to growers of \$14 million per annum, assuming an annual rail based export shipping program of 7.0 million tonnes.

#### 1.2.3 Comparison with Regimes in Other States

The apparent ineffectiveness of the WA rail access regime has parallels in Queensland and Victoria:

- Queensland has Australia’s most codified regime, the result of an extensive analysis and consultation process, accompanied by voluminous publications. It is essentially a negotiate-arbitrate regime with floors and ceilings, and considerable prescription to force Queensland Rail to respond appropriately to access requests. Our understanding of current thinking in Queensland is that the regime is effective for coal and for coastal container freight (eg Toll’s Brisbane - Cairns service) but unlikely to be effective for grain. The lower revenues at stake with potential new entrants for grain freight, combined with the complexity of the regime, make access unlikely.
- Victoria started with a much simpler negotiate – arbitrate regime based on average prices close to the floor concept (as past investment in the infrastructure was treated as sunk), but access did not occur. Access applicants (eg Graincorp) received price quotes that were too high for their proposed services to be economic. The former CEO of the incumbent railway, then Freight Australia, made known his opposition to third party access. The Victorian government undertook a fundamental review of the regime; it has not yet announced its final position, and its latest publication (on a legislative framework<sup>3</sup>) was produced in December 2004.

Access is however readily achieved on the interstate track and on NSW track, each owned by parties which are independent of rail operators, and managed by the (mostly) independent ARTC. There are several operators on the interstate track, and a substantial number on NSW track. AWB’s own experience in Victoria bears this out – third party access was easy on the interstate line but was not achieved on the Victorian lines. The observed behaviour is consistent with the incentives at play: a vertically integrated operator (i.e. one which has a long term lease over the infrastructure) has an incentive to keep rivals off, whereas a vertically separated infrastructure provider has an incentive to get more operators on (to spread its fixed costs).

This suggests that review of the WA regime should go deeper than a tweaking of the current documentation. It should also await the outcome of the Victorian review and the WA network review.

#### 1.2.4 Conclusion on the Effectiveness of Access

To date there has been no significant entry into the Western Australia rail freight market other than interstate operators. This makes it difficult to assess whether the lack of access is the result of a lack of profitable opportunities or because of barriers to entry. Details of attempted access have not been published by the regulator.

The ERA made the statement on page 14 of their Issues Paper that *“recent experience suggests that third party access is more likely to be encouraged where the infrastructure provider has strong incentives for this to occur. In other circumstances, the regulatory framework may need to be more detailed in order to prevent ambiguities arising that could provide an avenue for the infrastructure owner to delay third party entry to the network”*. AWB agrees, and believes that its experience indicates that the strongest incentives are provided by the vertical separation of the infrastructure operator and owner.

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<sup>3</sup> [www.doi.vic.gov.au/freight](http://www.doi.vic.gov.au/freight) and logistics

It is evident that the success stories in terms of contestable markets have occurred in the Interstate and New South Wales markets, where the full separation of infrastructure from above the line operators has led to the swift and beneficial emergence of competition. When we look at the virtual separations in other states, achieved through the ring-fencing of separate legal entities, we see no cases of successful access. The only exceptions to this rule are in highly profitable rail markets, for example transporting coal within Queensland; in this market the gains from securing access are large enough that an access seeker will not be deterred by obstacles presented by the infrastructure owner.

The market for grain transportation in Western Australia is not sufficiently profitable that an access seeker would not be deterred by a high offer price from the infrastructure owner. The same situation applies in South Australia, Victoria and Queensland.

A lawyer's perspective (that of Luke Woodward) which reaches a similar conclusion is available on the ACCC website<sup>4</sup>. This indicates that vertically integrated infrastructure providers could create barriers to entry within the provisions of the Code by quoting high prices for access within the allowed timeframe and the price ceiling specified, and then tying up the process of granting access into a costly and lengthy dispute resolution process. This is borne out by Alcoa's protracted negotiations to obtain access (they have not been finalised despite being instigated in September 2001). Since arbitration judgements are not binding on successive access seekers, each seeker may have to pass this hurdle.

This problem is exacerbated by the distance between the floor and ceiling prices which may be determined with respect to the Costing Principles within the Code.

### **1.2.5 ERA's Perceived Benefits of the Code**

On page 10 of the Issues Paper, the ERA suggests that the Code has been instrumental in bringing about an 8.5% real reduction in access fees for larger customers. AWB considers that with regards to grain haulage, the reduction in prices has been brought about in response to increases in the increasing competitiveness of road freight, rather than the threat of rail entry.

AWB feels that there has not been sufficient analysis of the alleged benefits of the Code, nor adequate disclosure of the results of the WNR or AWR to assess whether these companies are earning excessive returns.

AWB would like to highlight that in response to a 55% increase in net tonnes per full time equivalent, the claimed average rate reduction has been only 8.5%; this indicates that most of the benefits of increased productivity are not being passed on to consumers. AWB would also like to note that the issues paper does not define the market from which this rate reduction is inferred.

In AWB's experience, in response to a request for access AWB was quoted a price which equated to 2.7 c/ntk. In AWB's experience this price is three times higher than that charged by other state operators and would prohibit profitable entry into the marketplace. It was felt that it would not have been possible to negotiate to a more reasonable price from such a high level. There were also concerns over the need to meet contractual commitments with ARG and the level of service that may have been received by ARG towards the end of their contract.

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<sup>4</sup> <http://www.accc.gov.au/content/index.phtml/itemId/353161>.



AWB would also like to note that the costs incurred in making an application for access and contributing to the formation of policy on this issue have been significant and suggest that the costs of pursuing an application for access may be prohibitive.

## **1.3 Key WA Rail Access regime framework components**

### **1.3.1 Rights and Obligations of Railway Owners**

The railway owner is given considerable flexibility within the price floor and price ceiling within which to set prices; this leads to uncertainty in assessing the attractiveness of entering the market.

### **1.3.2 Rights and Obligations of Access Seekers**

For access requests made under the Code, the access seeker may refer to the regulator for assistance. However, the preferred option of the regulator is for access arrangements to be made in private negotiations outside the Code. This forecloses the ability of access seekers to accept redress from the regulator. When one considers that access to essential facilities such as sidings must be negotiated outside the Code, this highlights the ease within which the railway owner can engage in gaming to protect the vertically integrated operator.

## **1.4 Subsidiary Framework Components**

### **1.4.1 The Costing Principles of the Code**

The Costing Principles are of fundamental importance to the effectiveness of the access regime established by the Act and Code, as they significantly affect the extent to which competition emerges in the market for rail operations. While AWB acknowledges that the actual prices paid to WestNet are determined by negotiation under the provisions of the Code, that position will always be subject to the "Floor Price Test" and the "Ceiling Price Test" under Schedule 4 of the Code: see clause 6 of Schedule 4 of the Code. If clause 9 of Schedule 4 of the Code does not apply, the Costing Principles will have a governing role in the determination of the relevant costs for the purposes of the Floor Price Test and the Ceiling Price Test in relation to particular access proposals.

The main point AWB wish to make on cost is that mechanistic application of the ceiling price test could result in access charges which are many times higher than can be justified. The ceiling is based on gross replacement value and a rate of return. GRV will be of the order of \$5 billion dollars whereas the amount paid for the whole railway (including rolling stock, other assets and goodwill) was of the order of half a billion dollars.

In particular many of the grain lines are relatively lightly used and it is questionable whether, if they had did not already exist, they would now be replicated. In other words the capital costs associated with them should be regarded as sunk and not justifying any return. The access charge then should only cover maintenance and overheads. This approach is consistent with correct economic signals as there is little further investment in the grain network taking place and as there is provision for recovering any capital expenditure on upgrading. The alternative of allowing an access price to move even part way up from incremental cost could result in a major increase in grain freight rates provided (by AWR or a rival) and could provide AWR with profits out of proportion to the investment made.

The CPA contains worrying signals with this regard, with the second broad objective outlined in page 2 of the Issues Paper suggests that is “*to facilitate efficient investment in natural monopoly infrastructure, especially by ensuring... infrastructure services are maintained and developed appropriately*”. AWB believes that this implies that the network is currently efficient and that it should be maintained, when in fact there remains inefficient network infrastructure which is funded through higher charges on other routes. AWB’s view is that this is not consistent with the objective of the Act which is to encourage a contestable market for rail operations and that the objective of Code is to protect the current rail network.

AWB is currently engaged with the Western Australia Government and key grain industry groups to identify the extent to which there are inefficiencies in the network. The outcome of this analysis will inform the regulator as to the extent of inefficient infrastructure which should not be supported through access charges.

AWB is concerned about a floor and ceiling approach with the ceiling based on standalone costs: there would be a large gap between the ceiling and floor and setting a price within it would strain a negotiate-arbitrate approach which is prone to gaming and delays. If there is to be a ceiling it would be better placed on contributed costs such as major periodic maintenance and upgrades since privatisation.

An example of the application of the floor and ceiling pricing model, based on data for a lightly used rail line was provided in the South Australian rail access publication, “Railways Access in South Australia Information Kit Transport SA” published by the Government of South Australia. The application of the “floor and ceiling” pricing model in the example produced a floor of approximately 0.2c/gtk and a ceiling of approximately 9c/gtk.

A large discretionary range for access pricing is likely to hinder private negotiation by an access provider and an access seeker. The gap between floor and ceiling would be too great to provide sufficient guidance for price setting, especially given the limitations of the negotiate-arbitrate process discussed in section 1.2.4 above. The likelihood that parties would have to resort to dispute resolution of the terms of access carries with it the associated likelihood of higher transaction costs.

We also note that there are obvious incentives for the monopoly supplier to price at or near to the ceiling price allowed under the Code, particularly as the indicative starting price for negotiations. This is an undesirable situation, and AWB believe that the Code should provide guidance to direct prices to a more reasonable basis for negotiation.



The Code does not appear to provide clear guidance on this matter apart from a reference to market conditions — which would allow WestNet to determine somehow that grain market conditions allowed a substantial rate increase. AWB would not accept such an outcome and so a dispute would be triggered.

#### **1.4.2 Segregation Arrangements**

AWB has serious reservations about the effectiveness of the segregation arrangements. These have been communicated to the ERA in a prior submission from AWB<sup>5</sup> and for brevity we refer the reader to this document.

#### **1.4.3 Train Management Guidelines, Train Path Policy and Overpayment Rules**

These three subsidiary framework components have been determined through an adequate consultation procedure and appear to be sound in principle. However, these principles remain untested due to the absence of any entry in the marketplace.

### **1.5 Other Issues Within the Code**

#### **1.5.1 Uncertainty**

In page 14 of their Issues Paper, the ERA made the comment that “*there needs to be a balance between the amount of prescriptive detail in the regulatory framework and the flexibility to achieve commercially negotiated outcomes*”.

AWB believes that the provisions of the Code do not provide enough detail to allow potential entrants to make a realistic assessment of the costs which they may face, and the burden on non-price access conditions, and that this uncertainty is prohibitive in terms of making an assessment as to whether WRN is offering reasonable charges for access.

#### **1.5.2 Fines for Non-compliance**

The maximum fine for non-compliance with the Code is capped at \$100,000. Given that AWB spent \$90 m - \$100 m on rail in WA for the 2003/4 period, the maximum fine therefore represents approximately 0.1% of AWB’s expenditure on rail services in Western Australia in 2004. If the infrastructure owner could deter entry into the marketplace through behaviour that would be considered non-compliant, it could avoid losing revenue of up to \$100 m. In a business with low variable costs, this would protect a similar magnitude of profits. Thus a fine of only \$100,000 would not serve as any kind of deterrent to non-compliant behaviour.

The Code needs to increase the level of potential fines such that the maximum fine is at least as great as the expected gains to non-compliance. With this strategy, the maximum fine should increase as the probability of detection decreases.

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<sup>5</sup> [Submission to Office of the Rail Access Regulator – Jan 2002]