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17 April 2014

Inquiry into the Management of Western Australia's Freight Rail Network

Dear Dr Abernethie,

Aurizon welcomes the opportunity to provide this submission to the Economics and Industry Standing Committee Inquiry into the Management of Western Australia's Freight Rail Network.

Aurizon has significant interest in the land transport task in Western Australia. Until recently Aurizon was the only intrastate above rail operator on the network managed by Brookfield Rail. Aurizon's iron ore operations in the south west of Western Australia have grown to 24.7 million tonnes in 2012/13[1] and Aurizon continues to investigate opportunities to leverage its core business within the existing operating footprint as well as growth opportunities in the Pilbara.

Broadly Aurizon is supportive of any process that improves certainty and transparency in relation to the long term policy settings for Western Australian railways. Given the majority of Western Australia's exports arrive to port via rail, maximising supply chain productivity is fundamental to maintaining the competitiveness of the State's primary industries.

All stakeholders in the future of Western Australian industry have an interest in the long-term sustainability and competitiveness of the railway network. This shared objective should drive, in most instances, a commercial solution to the productivity challenge.

The primary role for government in relation to the railway, is ensuring that its two primary regulatory instruments – namely, the administration of the lease with Brookfield Rail, and

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1 Hockridge, L., "Aurizon Full year results presentation", 19 August 2013, p 34, http://www.asx.com.au/asx/statistics/announcements.do?by=asxCode&asxCode=azj&timeframe=Y&year=2013, Downloaded 11 April 2014

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the application of the Western Australian Rail Access Regime (the WARAR)[2] – work together effectively in order to ensure that the infrastructure manager meets its obligations to the Western Australian community and to those who rely on the efficient operation of the brownfield network. In an environment where each State is once again reviewing the role of government in providing public infrastructure, Aurizon considers it appropriate to consider the existing arrangements and any improvement opportunities to deliver the next wave of productivity improvements for significant infrastructure in Australia.

For Aurizon, the most important issue is ensuring that there is no misalignment between the prices that are collected for use of the infrastructure and the standard of the network itself. Those who use the network should be expected to pay a reasonable tariff, but should also be entitled to receive a commensurate quality of service. This is best facilitated where the terms and conditions of access, including price, are commercially negotiated, and sufficient information is available to both parties to assess the risk of non-performance.

In this respect, the misalignment between the treatment of infrastructure condition in the State's regulatory instruments is notable. In particular, access seekers are currently required under the WARAR to pay a tariff that is orientated to the very substantial, actual replacement cost of the assets – even though the actual standard of the present-day infrastructure is far from the standard of 'new' replacement infrastructure. Despite this, the railway manager under its lease is only required to maintain the network to the standard at the commencement of the lease, a condition generally regarded as poor, given the low purchase price and substantial remedial capital expenditure cost that has since been incurred. In other words, the regulatory settings allow the railway manager to charge tariffs that reflect a brand new network, for a network of a standard that is anything but brand new.

In considering the instruments that apply to the Western Australian rail freight network, Aurizon will discuss in this submission the following key observations:

- Effective negotiation between service providers and access seekers requires information to be available to address asymmetries and facilitate access seekers assessment of risk.
- The corridor lease combined with the rail access regulatory regime, in certain circumstances, incentives cost minimisation behavior of the below rail manager that may result in declining service levels. It also incentives the avoidance of investment in what is a long life asset well before the end of the lease.
- The standard of rail infrastructure and the associated service levels have the potential to impose significant costs on above rail operators and users of the network. The lease was constructed with the ability to mitigate these risks via the infrastructure performance standards review mechanism. These have not been updated since the commencement of the lease in the year 2000 even though over $2.4 billion has been spent on the leased railway in the past 10 years[3].
- Aurizon supports the Auditor General's findings that the "PTA and Transport should implement a formal contract management plan to guide the management of the 49 year rail freight network lease. This plan should be based on a thorough risk assessment and include consideration of the State's objectives for the near-term and long-term management of the lease and the network."[4]
- The lease obligations, performance standards, maintenance and asset condition reports should be made available as part of the required information included in the WARAR.
- Given the significant variation between the standard that could be expected using the modern engineering equivalent valuation and the actual standard of the infrastructure, the undertaking of the review of the costing methodology as

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[2] The Railways (Access) Act 1998 (the Act) and the subsidiary legislation the Railways (Access) Code 2000 (the Code)

[3] Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.11

[4] Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.10

proposed by the Auditor General[5] should include a review of the asset valuation methodology.
- Aurizon supports the implementation of the recommendations from the review of the WARAR conducted in 2010/11, most specifically the requirement for information to be publicly available on network providers websites.
- Aurizon supports the review of the regulatory regime in 2014 in line with the legislative requirements for the Code to be reviewed every 5 years with the first commencing in 2004.

Related obligations between lease arrangements and third party access arrangements

Aurizon supports the review of both the corridor lease and third party access arrangements when assessing the impact of the management of the rail freight network on state development.

The rail access regime in Western Australia is based on the negotiate – arbitrate model and is relatively light handed. Similarly to the Interstate Access Undertaking[6] the WARAR subsidiary legislation, the Code, is required to be reviewed by the regulator every 5 years[7]. However the Code does provide for greater regulatory involvement through both the term of the Code, for example the approval of Part 5 instruments and re-setting the WACC annually, as well as during the negotiation for access. For example a negotiation for access under the Interstate Access Undertaking would only involve the regulator in the event of dispute, however the Code requires the regulator to make a number of rulings as part of the process for gaining access, as well as in the event of dispute.

To facilitate an effective negotiation with infrastructure owners, third party access regimes require the provision of sufficient information to ensure that the risks associated with the provision of services can be assessed and priced during the negotiation process.

In most regulated industries the service provided is standardised – each customer receives a relatively homogenous service with equivalent levels of service quality from the infrastructure provider.

This is not the case in the rail industry, where service levels can vary on a number of factors including speed, rollingstock characteristics (including payload, tare, noise levels, environmental impacts) and levels of reliability. For the above rail operator the below rail service quality is dependent on first the standard of infrastructure and secondly the allocation of the capacity derived from the infrastructure standard. Likewise for the below rail manager the fundamental costs and risks are driven by the rollingstock interface with the track. Recent productivity improvements in the rail industry have included reducing the weight and/ or number of rollingstock to allow for greater volumes of freight for the same infrastructure standard, improved braking technology to decrease transit time, reducing the separation between trains to increase capacity from existing infrastructure, improving wayside detection equipment to proactively manage rail infrastructure.

One of the key risks that have arisen from the introduction of the third party access regime in the rail industry is the circumstances where the above rail operator and below rail managers have divergent incentives. A particular area of concern in this respect is in relation to the long term standard of the infrastructure. Whilst in the long term the interests of each party are aligned for growth of freight on rail, in the short to medium term conflicts arise. The role for governments is to ensure that the conflicts are not unintentionally exacerbated by the regulatory instruments used to achieve government policy.

Whilst the WARAR addresses the terms and conditions of access (including the price), the freight network lease will drive a key determinant of both service quality and price,

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5 Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.10

6 ARTC's Interstate Access Undertaking for the national interstate rail network in favour of the Australian Competition and Consumer Commission, commenced in July 2008.

7 The term of the interstate access undertaking is 10 years but with a mid-term review cl 2.4(f).

that is the infrastructure standard. The above rail operators rely on government's interest in the long term sustainability of the rail network aligning with their interests in an efficient network. Where service levels decline or the incentives of either government or the railway manager appear to be in conflict, the effectiveness of the regulatory instruments are naturally questioned.

The proposed closure of the tier 3 grain lines is ultimately a question of investment in transport infrastructure (whether road or rail). This is a complex and difficult issue whose ultimate goal is to optimise the modal share of complementary services being road and rail. Aurizon supports the transparency of the decision making process regarding the assessment of the relative merits of government investment in road or rail infrastructure, including this Inquiry into the management of the rail freight network lease.

Risk based approach to managing the freight network lease

The Auditor General's report into the management of the rail freight network lease[8] provided the first transparent view of the objectives of the rail freight network lease and the effectiveness of achieving government policy. In doing so, it highlighted opportunities to improve the transparency of risk associated with the lease of the State's rail freight network not only to ensure that the "State's asset is maintained and handed back in a fit for purpose condition"[9] but also to ensure that the asset continues to contribute to productivity growth in Western Australia.

When the rail freight corridor land was originally leased to WestNet in 2000, the lease arrangements were comprised of two agreements:

- the Rail Freight Corridor Land Use Agreement (Standard Gauge) and Railway Infrastructure Lease dated 17 December 2000; and
- the Rail Freight Corridor Land Use Agreement (Narrow Gauge) and Railway Infrastructure Lease dated 17 December 2000.[10]

The Auditor General reported that the lease and its variations have not been tabled in Parliament and no regulatory agency publicly reports on the condition of the network or its use[11].

Instruments incentivise cost minimisation at the expense of service levels in the short term to medium term

The WARAR includes the gross replacement asset valuation (GRV) methodology for determining the ceiling cost of access to the rail infrastructure. The GRV methodology assumes the asset is maintained in a new state and continually reflects the modern engineering standard. For ageing assets this valuation methodology means that the upper revenue ceiling limits are independent of the asset's actual condition. Consequently, price is not cost reflective and does not reflect actual service levels and the service provider can earn revenues well in excess of the costs incurred in maintaining and renewing the assets. In addition, unlike other regimes where the review by the regulator of forecast and actual maintenance costs provides some mitigation of the risk of a decline in service levels, there is no such process under the WARAR.

In an environment where volume growth is limited, the GRV methodology can incentivise cost minimisation, generally a reduction in maintenance costs, to maximise the margins of the below rail manager. This in itself is not problematic. Of concern to users is whether:

- the decline in service levels and consequential costs imposed on other parts of the supply chain is the optimal trade-off; and
- growth projects ultimately fund the maintenance deficit in guise of 'capacity enhancement'.

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8 Published January 2013

9 Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.6

10 WestNet Rail, Train Path Policy, November 2001, p.2, Downloaded: 15/4/2014, http://www.erawa.com.au/cproot/3391/2/pathpol_151101.pdf

11 Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.9

Of course, in reviewing the lease arrangements, consideration must be given to the property rights of the lessee. The rail freight lease agreement rightly provides flexibility to manage changes to service levels and standards over time. Aurizon therefore considers that the issues associated with the standard of infrastructure are contemplated by the lease and therefore are issues of the management of the lease, and do not require any alteration to the underlying property interests of the lessee. This is not to say that the lease obligations cannot be replicated within the code and reported on in a transparent and public way.

Where capacity enhancements have been undertaken to increase volumes on the rail network over time, there should be a corresponding improvement in network performance levels. Increased network performance levels have a direct impact on reducing rail operator costs, which increases the competitiveness of the supply chain. Maintaining minimum network standards to year 2000 levels (where annual volumes were about 30m tonne per annum) does not appear to be in the best interest of the State's export industries.

Aurizon supports a review of the performance standards as contemplated by the lease. In addition, as the GRV approach does not provide any regulatory scrutiny of the asset condition, Aurizon supports the publication of the lease obligations including the performance standards, maintenance and asset condition reports and an alignment between the performance standards included in the lease with the information required to be made available through the WARAR.

Differences in the life of assets and term of the lease impacts incentives

A further risk identified by the Auditor General is the divergence of the interests of the lessee and the State as the lease approaches the end of term[12]. Of particular concern is that the funding of any maintenance deficit by the lessee is provided for only in relation to the final 5 years of the lease.[13]

Rail infrastructure is a long life asset with many items having greater than 50 year useful life. In managing rail infrastructure trade-offs are made regarding operating versus capital maintenance. The best indicator of this is where temporary speed restrictions are imposed to manage declines in the infrastructure standard and are in place for a significant amount of time. The misalignment between the term of the lease and the asset life creates incentives for the service provider to:

- avoid investment by requiring productivity investment to be achieved through rail operator investment; or
- pricing investments to ensure its recovers its cost within the term of the lease even though the investments will continue to provide economic benefits after the lease expiry (which may price the services out of the market); and
- to sweat the assets to the extent possible as the termination date of the lease nears (potentially leaving a large maintenance deficit being transferred to the state or subsequent lessee).

Whilst the lease provides for penalties in relation to non-compliance with maintaining the lease in a standard 'fit for purpose' unless the lease is managed proactively the risk to the State and users of the rail infrastructure increase.

On this basis, Aurizon supports the Auditor General's findings that the "PTA and Transport should implement a formal contract management plan to guide the management of the 49 year rail freight network lease. This plan should be based on a thorough risk assessment and include consideration of the State's objectives for the near-term and long-term management of the lease and the network."[14]

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12 Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.10

13 Rail Freight Corridor Land Use Agreement (Narrow Gauge) and Railway Infrastructure Lease, cl.15.13 Downloaded www.sec.gov

14 Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.10

It is important to recognize that information that is available to regulators is imperfect and cannot replicate what would be available in an efficient market. As such, Aurizon considers that the risk assessment and reporting against the performance standards should involve a public consultation with users of the infrastructure.

Transparency of policy objectives

Aurizon considers the transparency of Government policy objectives is required to ensure that users of the network understand the risk to operations. For example one of the policy objectives mentioned in the lease arrangements was to ensure that a person using or occupying that part of the Network comprised of standard gauge track has a financial or legal interest in the continued maintenance and operation of the narrow gauge track.[15] The Auditor General's report has stated that this objective is achieved through "two main means: the inclusion, and ongoing adjustment of performance standards, and the application of a State-controlled process for the surrender or support of marginal lines."[16] The objective could equally have been achieved at the time of the lease through the vertical integrated nature of the originally privatised business and legitimately price differentiating between individual services whilst maintaining total revenue for both the standard and narrow gauge lines in Western Australia.

As noted by the Auditor General, the structural separation of the vertically integrated rail business in 2006 has meant that the internal co-ordination (or trade-offs) of investment between above and below rail no longer occurs[17].

The Auditor General does refer to the need to identify the correct method for applying costs to assess whether a line is uneconomic and qualifies for State support. However this cost based approach to pricing does not appear to address other legitimate pricing approaches such as market based pricing, or indeed whether the asset valuation used is appropriate in all circumstances. For example there are significant merits in adopting a depreciated optimised cost basis for asset valuation in the circumstances where the asset condition is in fact below modern engineering equivalent standard. For instance "where an overvaluation of sunk assets, when eventually overlaid with a commercial rate of return on invested capital, may 'crowd out' capital expenditure in other parts of the supply-chain"[18]. In the case of the leased assets in Western Australia there is an objective asset valuation that can be relied on namely the indexed acquisition price.

Aurizon supports a review of the costing methodology for uneconomic lines and should be assessed relative to the original policy objective of ensuring that a person using or occupying that part of the network comprised of standard gauge track has a financial or legal interest in the continued maintenance and operation of the narrow gauge track. That options would include a review of the asset valuation methodology and the apportionment of overhead costs. To this end, Aurizon considers it is in the interests of all stakeholders that the rationale for the determination of the floor and ceiling costs relating to Co-operative Bulk Handling's 2013 Access Proposal is made public.

Review of the WARAR

The WARAR regulates the prices and other terms and conditions for access to rail infrastructure services. It not only applies to Brookfield Rail's network in the south west of Western Australia, but also FMG's rail network managed by the wholly owned subsidiary

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15 Recital E(c) in both Rail Freight Corridor Land Use Agreement (NarrowGauge) and Railway Infrastructure Lease, 16 December 2000, downloaded 15/4/2014, http://www.sec.gov/Archives/edgar/data/1012620/000089375001000146/0000893750-01-000146-0005.txt and Rail Freight Corridor Land Use Agreement (StandardGauge) and Railway Infrastructure Lease, 16 December 2000, downloaded 15/4/2014, http://www.sec.gov/Archives/edgar/data/1012620/000089375001000146/0000893750-01-000146-0006.txt

16 Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.18

17 Western Australian Auditor General's Report, Management of the Rail Freight Network Lease: Twelve Years Down the Track Report 1 – January 2013, p.16

18 Aurizon, Queensland Rail's Access Undertaking (AU1), West Moreton Reference Tariff Submission, 31 October 2013, p.16

The Pilbara Infrastructure and is intended to apply to the Roy Hill rail network[19]. Until recently the WARAR was relatively untested in that no party had actually applied for access to services under the Code but rather choosing to negotiate commercially with the specific network provider. There are many different reasons for this historical approach with each party seeking access to the network assessing the relative costs and benefits of negotiating under the Code or outside of the Code.

Regardless of whether the WARAR had been utilised to gain access to services it has provided the safety net to commercial negotiations since inception. To the extent that a negotiation breaks down either outside of the Code or under the Code, the WARAR is available for dispute resolution[20].

Under the Act, the Economic Regulatory Authority (ERA) must review the Code "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."[21] The review was last conducted in 2009 (the second review), with the next review due to commence in late 2014[22].

Implementation of recommendations of the Second Code Review

The final report from the second review of the Code was given to the Treasurer, for his consideration, on 23 December 2011 and was published in February 2012. As at the date of this letter the recommendations from the second review of the Code were yet to be implemented. In that review there were two recommendations that related to the transparency of information.

Firstly that the information required to be published by the railway owner under section 6 should be published on the railway owner's website[23]. This would include the form of the railway owner's standard access agreement and the information described in Schedule 2 regarding the technical information of the infrastructure, volumes and proposed capital works. The level of information publicly made available on websites is inconsistent and does not reflect in full the requirements of section 6. Aurizon considers this recommendation is still of value to access seekers in ensuring that information is readily available to provide for a timely and effective negotiation. As stated by the ERA, "modern information technology has minimised the cost of maintaining and providing technical information and therefore a mandatory requirement to publish this information on a website would not have a major impact on costs."[24]

Secondly, a requirement for capacity information provided by the railway owner must be compiled on a reasonable basis[25]. Under this requirement it would appear reasonable that any capacity evaluation should be based on the agreed infrastructure performance standards in the network lease. Access proponents would then be able to assess current performance to determine the risk to operations of capacity not being available or the risk associated with increased costs over the term of the contract.

Third review of the Code should proceed at the end of 2014

As previously mentioned the third review of the Code is due to commence in late 2014. Since the last review, the WARAR has been certified as an effective regime and there have been two access proposals that have commenced under the WARAR. The benefit of both of these processes have been to identify specific concerns regarding the

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19 Albeit the Roy Hill State Development Agreement provides an option for the rail infrastructure to be regulated by a voluntary undertaking under the Competition and Consumer Act 2010.

20 Albeit a negotiation outside of the Code will generally have to be re-commenced under the Code and therefore the timeframe to resolve disputes using the Code will need to consider this.

21 Railways (Access) Act 1998, s 12.

22. Railways (Access) Act 1998, s 12 and National Competition Council (2010), Western Australian Rail Access Regime, Application for certification as an effective access regime – section 44M Trade Practices Act 1974 (Cth), Draft Recommendation, 17 August 2010, p.50

23 Economics Regulatory Authority (February 2012), Review of the Railways (Access) Code 2000 Final Report December 2011, Final Recommendation 1, p.1

24 Economic Regulatory Authority, Review of the Railways (Access) Code 2000, Draft Report, November 2010, p.7

25 Economics Regulatory Authority (February 2012), Review of the Railways (Access) Code 2000 Final Report December 2011, Final Recommendation 2, p.1

operation of the WARAR based on the experience in other regimes and to provide practical examples of the operation of the rail access regime in Western Australia.

It seems clear that the technical information about the rail infrastructure that is required to be provided by the Code must transparently align with the performance standards included in the freight network lease. In addition, under the lease the railway owner is required to submit a maintenance plan every 5 years. This information together with a reconciliation between the previous 5 year plan and the actual expenditure would assist in providing significant information to access proponents on the service levels and changes to cost of access over the term of the contracts. The Auditor General's report has provided some transparency on the misalignment between the information required to be produced under the WARAR and the risk to users of the rail freight network associated with the management of the lease.

It is Aurizon's view that the next review of the WARAR provides a timely opportunity to address identified gaps in the transparency of infrastructure standard information available under the WARAR.

Should you have any queries in relation to this submission please contact Samuel McSkimming (07) 3019 9024.

Yours Sincerely,

Prue MacKenzie
Vice President
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