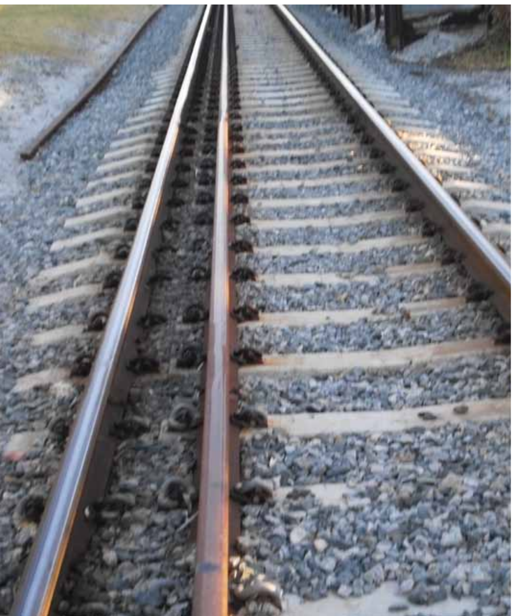
Western Australian Auditor General's Report

Management of the Rail Freight Network Lease: Twelve Years Down the Track

Report 1 – January 2013



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WESTERN AUSTRALIAN AUDITOR GENERAL'S REPORT

Management of the Rail Freight Network Lease: Twelve Years Down the Track

Report 1
January 2013

THE PRESIDENT
LEGISLATIVE COUNCIL

THE SPEAKER
LEGISLATIVE ASSEMBLY

PERFORMANCE AUDIT: MANAGEMENT OF THE RAIL FREIGHT NETWORK LEASE: TWELVE YEARS DOWN THE TRACK

This report has been prepared for submission to Parliament under the provisions of section 25 of the *Auditor General Act 2006*.

Performance audits are an integral part of the overall audit program. They seek to provide Parliament with assessments of the effectiveness and efficiency of public sector programs and activities, and identify opportunities for improved performance.

The information provided through this approach will, I am sure, assist Parliament in better evaluating agency performance and enhance parliamentary decision-making to the benefit of all Western Australians.

COLIN MURPHY
AUDITOR GENERAL
3 January 2013

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Auditor General's Overview

The replacement cost of the State's rail freight network is over $5 billion. Its real value and importance lie in its role as a fundamental enabler of economic activity and development. Twelve years ago the State divested itself of operating and maintaining the network by leasing it to a commercial operator for 49 years.

The network operates in a dynamic environment, where the market, policy and risks change. Part of that environment is a debate in the community about whether road or rail is better for carrying freight, and certain types of freight in certain areas. This report does not engage in the road versus rail debate. That is properly a policy debate for Parliament, government and the community to have.

The lease of the rail freight network was set up to do a number of things. It was intended to facilitate investment in, and growth of, the network by allowing the commercial operator the freedom to respond to market needs and derive a return. It was also intended to ensure that the State's asset is maintained and handed back in a fit for purpose condition, and to allow the State to pursue its policy objectives and protect its interests, particularly where those may diverge from the operator's commercial interests.

So far, this approach has largely worked. However, 37 years are left on the lease term and a range of risks remain that the State needs to manage. The nature of these risks will change over the course of the lease as market needs, commercial imperatives and government policy also change. To manage the lease effectively will require a more structured and risk based approach than has been employed to date. This should also enable the PTA to maintain a 'light touch' while protecting the State's interests and identifying and addressing risks as they arise.

Parliament authorised the lease of the rail freight network through the *Rail Freight System Act 2000*, and in doing so added a number of obligations to the lease. Since then, however, it has received little information on the lease and the network, restricting the extent to which it can reach an informed judgement on the effectiveness of the lease arrangements. This report will help to address that, and will hopefully contribute to the effective management and maintenance of this essential and valuable State asset.

Executive Summary

Background

The 5 600km Western Australian rail freight network is a strategic infrastructure asset of national importance, carrying around 80 million tonnes in 2012. It remains in State ownership, but has been leased until December 2049 to a private rail operator. The lease arrangement was designed to allow the government to pursue its policy objectives for the network, while allowing the lessee to pursue its commercial interests without undue interference.

The lease enables commercial experience and incentives to be brought into the maintenance and upgrade of the network, subject to policy controls that remain with the State. Provision is made for the network to adapt to changing demand and new technology by allowing the performance standards to be updated by agreement every five years, or when there is a material change in circumstances. The revision of these performance standards is guided by the principle that the entire network should remain 'fit for purpose'. Performance standards can be raised or lowered wherever the State and the lessee agree that new standards are required to meet the requirements of rail users and remain in step with changes in rail technology.

At the time of drafting the lease, the State recognised that some narrow gauge grain lines would be unlikely to operate profitably for the lessee, particularly in low-harvest years. From December 2006 the lease allowed the lessee to surrender certain lines or request state funding where a line is carrying low traffic and is expected to make a loss over the next three years. In these cases, the government may resume the line or make arrangements to prevent the lessee making an ongoing loss.

The lease establishes a monitoring and reporting regime and empowers the Public Transport Authority (PTA) to supervise compliance, while the Department of Transport (Transport) manages long-term transport planning, determining future needs and investment priorities for rail freight infrastructure. The parties to the lease envisaged a 'light touch' approach to supervision and intervention from government where the interests of the State and the lessee are well-aligned through the lease. Where the interests of the lessee and the State may diverge, a risk-sensitive and proactive approach was anticipated.

The network is influenced by changing market and environmental conditions, technology, regulatory requirements and the lessee's commercial priorities. Effective management of the lease is a complex task requiring a close understanding of these dynamics, including the long-term and immediate effects of decisions regarding maintenance and capital upgrades. Market conditions change, but a well-devised contract management approach should enable the State to benefit from economic growth while also protecting against emerging and known risks.

The audit objective was to assess the management of the 49 year rail freight network lease by the PTA and Transport by determining whether the outcomes to date are in line with original objectives and whether the agencies are managing the rail freight lease to protect the State's interests into the future.

Audit conclusion

Many of the original objectives from the lease of the rail freight network have been achieved, including removing government from operating the freight rail network, and its associated costs, and paying down debt. The volume of freight carried on the network has increased and the condition of the standard gauge lines, and the narrow gauge lines used for mineral freight, has improved.

The condition of the narrow gauge lines used primarily for carrying grain has degraded. The 'grain lines' have required substantial government funding to remain in service. Two of the uneconomic 'Tier 3' grain lines have been placed in care and maintenance, and without further government funding, the remaining eight are likely to be taken out of service after 2013. Ongoing government funding was anticipated at the time of the lease, but not quantified, so it is not possible to conclude whether actual levels of support are more or less than originally estimated.

To date, PTA has managed the lease without a formal risk-based contract management plan, making it difficult for PTA to demonstrate that it has fully considered the impact of decisions about the lease and network on the State's interests over the life of the lease. PTA is now preparing a plan, which should help better manage risks and to protect the State's interests, while also enabling PTA to maintain the 'light touch' approach envisaged in the lease.

The State faces significant risks over the remaining 37 years of the lease. Specifically these relate to keeping track performance standards up to date, monitoring maintenance on certain lines, the need to adapt or step outside of the lease to meet policy objectives on the grain lines, the application of costs to uneconomic lines, and end of lease issues. A risk-based contract management plan should strengthen PTA's capacity to manage these issues in a considered and proactive way.

Key findings

- The sale and lease of the rail freight network met many of its original objectives. The State was able to step out of the freight rail business, freeing itself from the costs of running the network, and many of the risks of owning the network. The network was leased for a single up-front payment of $292.5 million, while the business of Westrail was sold for $294.2 million, together totalling $586.7 million. The proceeds allowed the State to reduce debt.
- The mineral and general freight carrying lines are in better condition now than when they were leased. There has been a significant increase in the overall volume of freight since 2000, supporting and reflecting the strong economic growth of the State. By 2009, the network was carrying 54.4 million net tonnes of freight, almost 70 per cent more than in 2000. The lessee expects that freight will grow to 85 million net tonnes by 2013 – more than two and a half times the volume carried in 1999 when the lease was planned. The State does not obtain any direct economic benefit from this increase in volume, but benefits indirectly from increases in State-wide economic activity and improvements to the network assets by the lessee.
- The State retains some risks and liabilities and, as was anticipated, has continued to provide funding for the network. Between 2000 and 2011, State and Commonwealth funding spent or committed to the leased network totalled around $360 million. Around $102 million of this has been contributed by the State, and $258 million from the Commonwealth. It is not possible to assess whether this is in line with original expectations because the expected level of State investment in the network was not quantified at the start of the lease.
- Significant sections of the narrow gauge network mainly used for carrying grain have degraded and two lines have been withdrawn from service. A 2010 agreement between PTA and the lessee identified that without State funding for re-sleepering work, 67 per cent of the grain network (1 450 kilometres of track, including nine Tier 1 and 2 lines) would be placed in care and maintenance by 2013–14, and 90 per cent of grain lines would fall below the condition required in the lease. The re-sleepering works were estimated to require $241.5 million in government funding. Some of the required funding was approved before the agreement was signed, and government has funded the required works on Tier 1 and 2 grain lines, but not the $93.5 million of work on the 10 Tier 3 lines. These lines were identified as not suitable for further investment in the 2009 Strategic Grain Network Committee Review.

- To date, two Tier 3 lines have been placed in care and maintenance due to lack of use, and government provided funding of $3.3 million for maintenance works to keep four Tier 3 lines open until the end of October 2012. The lessee will keep these lines open until the end of October 2013, without additional government funding. Under the 2010 agreement, without further funding after October 2013, the Tier 3 lines can be placed in care and maintenance.
- Available documentary evidence indicates that an additional $400 million investment commitment was made by the successful bidder during the tender process, but this was not incorporated in the lease. There is no clear record of why.
- Limited information is available to Parliament and the public regarding the lease of the network or its condition. The lease and its variations have not been tabled in Parliament, and no regulatory agency reports publicly on the condition of the network or its use. The 2005 track condition report was tabled in Parliament, but the 2010 track condition report has not been made publicly available. PTA's capacity to report on the condition of the network or its use is restricted by the type of information it deems necessary to obtain from the lessee in order to manage the contract. In our view PTA's capacity to hold the lessee to account would be better served if it had a more comprehensive understanding of the work done and condition of the network
- The lease anticipated a relatively 'light touch' role for government in managing the lease, which is appropriate given the State's original objectives. The State retains a range of risks related to market conditions, the lessee's commercial interests, and the policy of the government of the day. These risks require proactive monitoring and management.
- PTA has not had a contract management plan in place for the lease and has not yet completed a structured risk assessment, or formalised its ongoing objectives for the lease. This increases the risk that reactive decisions in response to individual issues may adversely affect the State's interests over the remaining 37 years of the lease. PTA began preparing a contract management plan in 2012 and advised that this plan should be finalised by the end of 2012.
- PTA has varied and adapted its implementation and management of the lease to reflect changing policy objectives on the 'grain lines'. PTA's explanation of how it reached these decisions is reasonable, but a more structured approach within a formalised contract management plan would enable PTA to better demonstrate the basis for its decisions.
- The correct method for applying costs to assess whether a line is uneconomic and qualifies for State support is unclear. The absence of an agreed method increases the risk that more lines will be regarded as making a loss, increasing the potential level of State funding.
- The lease contains 'fit for purpose' performance standards that are intended to ensure the network remains in the condition required by the State and by users of the network. There are a number of possible interpretations of 'fit for purpose' as used in the lease. Based on internal legal advice, PTA has interpreted the lease so that the only usable standards are the Initial Performance Standards, set at year 2000 levels. This is a substantial reduction of the 'fit for purpose' obligation, as it does not include the requirement to meet the needs of rail users or reflect changes in rail technology. This increases the risk of a gap emerging between the required standards and the needs of rail users, and the risk that at the end of the lease in 2049 the network will be required to be in essentially the same condition it was in 2000.

- The lease anticipates a review of performance standards every five years across the network, seeking to ensure that the standards remain in step with market needs and changing technology. The use of this mechanism is constrained by PTA's interpretation of 'fit for purpose', risking a situation where the five-yearly track condition reviews assess the condition of the network against outdated requirements. The initial performance standards have been changed in two instances since December 2000 – one where the State funded improvement works, and one to lower the standards to place lines into care and maintenance.
- PTA comprehensively reviews network condition and maintenance every five years, but more frequent monitoring would better match the risks on some lines, specifically those receiving government funding for maintenance, those at risk of becoming uneconomic, and lines requiring major infrastructure renewal.
- As the end of the lease approaches, the interests of the lessee and the State are likely to diverge. The lessee faces a commercial risk that the future benefits from its investments may flow to the State or to a new lessee, and this will affect investment and maintenance decisions by the lessee. End of lease issues are already influencing the commercial relationship, and will require monitoring and proactive management by PTA.

Recommendations

- 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.
- To proactively manage key risks through the contract management plan, PTA should:
    - clarify the appropriate accounting method for applying costs to 'uneconomic' lines
    - clarify the meaning and intended operation of clauses regarding 'fit for purpose' and the related adjustment of rail performance standards, to ensure standards stay up to date
    - adjust its monitoring over time and where appropriate to reflect emerging risks on specific lines, such as those at risk of becoming uneconomic, receiving government funding, or needing major upgrades
    - as part of the contract management plan, consider and formulate a strategy in relation to end of lease issues
    - collate and update all lease-related documents, variations, maps, plans, and performance standard agreements in a comprehensive lease management volume, to provide a transparent view of the lease and the network.

Joint response from the Public Transport Authority and the Department of Transport

In the past 10 years, the lessee (Brookfield Rail and its predecessor WestNet Rail) has spent over $2.4 billion on the leased railway infrastructure, and freight volumes have increased from 30 million tonnes per annum to over 55 million tonnes per annum, with volumes expected to increase by a further 45 per cent to over 80 million tonnes per annum within the next two years.

During this time of significant investment and growth, the PTA has managed the lease with a 'light touch' approach to allow private industry to manage the leased railway infrastructure in accordance with commercially prudent practices as envisaged by the lease arrangements.

The PTA will continue to manage the lease of the railway infrastructure in a manner consistent with both the legal requirements and intent of the lease and in doing so will fully consider the Auditor General's recommendations.

Audit Focus and Scope

The audit objective was to assess the Public Transport Authority and the Department of Transport's management of the 49 year rail freight network lease.

The focus of the audit enquiry was on two questions:

- Twelve years into the lease, are the outcomes to date in line with original objectives?
- Are the Public Transport Authority and the Department of Transport managing the rail freight lease to protect the State's interests into the future?

In conducting this audit we interviewed staff from the Public Transport Authority (PTA) and the Department of Transport (Transport). We reviewed legislation, policies, files and agency documents, and spoke with related regulatory agencies outside the scope of this audit, the Office of Rail Safety (ORS) and the Economic Regulation Authority (ERA). In addition, we sought the views of the lessee and of key stakeholders, and obtained expert legal and rail industry advice.

The following issues were excluded from the audit:

- examining the merits of the original sale and lease agreements in 2000
- examining the lessee's financial or other records
- engagement in the 'road versus rail' policy debate, or re-examining the assumptions or conclusions of the Transport Minister's *Strategic Grain Network Review Committee's* 2009 report on the grain rail freight network
- the work of related regulatory agencies, the Office of Rail Safety and the Economic Regulation Authority.

During this audit the Auditor General received information that some timber sleepers installed on the rail freight network did not meet the required standard, and that secondhand steel track components had been installed in some instances. We sought specialist advice and then requested the PTA to investigate the allegations which it did, using its own rail experts. PTA then provided the Auditor General with a written assurance that the sleepers and other components installed on the network met the appropriate standards. PTA also noted that as a general rule, the quality and life cycle of timber sleepers has declined over time as regulations have restricted the use of high-grade timber, and prohibited environmentally harmful weather-proofing agents.

The audit was conducted in accordance with Australian Auditing and Assurance Standards.

The evolution of the State's rail freight network

The State's rail freight network

The State's rail freight network is a significant and strategic component of the national transport infrastructure system. The State's dispersed population and export-oriented economy means reliable and efficient movement of freight is critical. Rail is one of the main modes for transporting goods within WA and is best suited for carrying heavy bulk commodities with regular, large volumes and long-haul cargos.

In 2011, PTA reported that the rail freight network had an estimated replacement value of around $5 000 million. In the financial year 2010-11, PTA recorded an annual depreciation expense of nearly $83 million as owner of the rail freight network on behalf of the State.

Source: Brookfield Rail

Figure 1: The rail freight network spans the southern part of the State from Geraldton in the north to Kalgoorlie in the east

The rail freight network consists of 5 600kms of track and other infrastructure located in the southern half of the State. The network assets consist of the tracks, bridges, sleepers, ballast, platforms, crossing loops, signals, and the land in the rail corridor. The network is made up of 'standard gauge', 'narrow gauge' and 'dual gauge' tracks (see Figure 1). As a general observation, the standard gauge network uses higher grade components that can carry heavier and longer trains at higher speeds.

The narrow gauge lines are found primarily in the agricultural regions, and 2 300 kilometres of the narrow gauge network is used almost exclusively for transporting grain. As a general rule, these grain lines tend to be less reliably profitable than those parts of the network carrying minerals and general containerised freight. This disparity was recognised at the time of the lease, and is common to many rail networks. The Strategic Grain Network Review in 2009 classified these 'grain lines' into three tiers, recommending continuing State investment in Tiers 1 and 2, and no further State investment in lines classified as Tier 3. The history of policy development on the grain lines is summarised in Appendix 1.

Historically, rail has carried around 60 per cent of the annual grain harvest, and in some regions this share is significantly higher. However, between 1999 and 2010, grain dropped from first to fourth when ranked on the weight of commodities moved on the network. This was not because the volume of grain freight had declined, but because of the significant increase in general freight and minerals carried on the network.

The rail network carries around 36 million tonnes a year of alumina, iron ore and bauxite, and these minerals currently make up around two thirds of all network freight.

The State's growing mining activity over the last 10 years has introduced a new dynamic for the grain network. An unprofitable grain line may become a highly profitable part of the network if a mine opens in the area, bringing significant private sector infrastructure investment and demand for rail freight services.

The State's rail freight network does not include the private railways in the Pilbara transporting iron ore to ports, the publicly owned metropolitan passenger light-rail system, or the Commonwealth operated transcontinental railway east of Kalgoorlie.

Maintenance is required to preserve the condition of the network and keep it operational. With age and use sleepers crack, line joints warp, and ballast degrades, which may result in reduced train speeds, delays, or even accidents. Planned maintenance includes replacing sleepers (wooden sleepers last around 20 years and concrete sleepers around 50 years), replacing ballast, clearing weeds and drains, and levelling and securing sleepers on a cyclical basis. Reactive maintenance occurs when a damaged component of the line is identified and replaced.

Upgrades to the line may include installing a heavier weight of rail track to carry heavier loads, or changing the alignment of the track to increase train speed by avoiding corners and hills. In some cases new sections of rail line called crossing loops are added alongside the existing track, so trains can pass each other without stopping. This results in the network safely carrying longer, faster and heavier trains, more frequently, and with fewer unexpected delays.

The components of railway lines are all subject to wear and tear from the weather and the movement of trains over the network, including steel rails, wooden, steel or concrete sleepers, crushed stone or rock ballast, and the track formation or base. The weight of the rail and the type of sleepers and ballast largely determine the maximum load and speed of the trains travelling on the line.

Rationale for leasing the network

Until the 1990s, government ownership of railways was common throughout Australia. In 1996, in response to rail's decreasing market share, Australian governments began increasing private sector involvement to foster efficiencies created by free market competition. This followed a commitment in 1995 by federal, state and territory governments to implement market reforms, including provision for third party competitive access to nationally significant infrastructure such as rail networks.

By the late 1990s the Western Australian government had decided to privatise the State-owned rail freight business. The rail freight system had accumulated a significant debt of around $1 billion to the WA Treasury Corporation and the Commonwealth. This debt was in part a result of estimated government expenditure of over $340 million between 1995 and 2000 on the network, including preventative maintenance and the 'grain line strengthening plan' in which '1-in-4' wood sleepers were replaced with steel.

The government held concerns that the business cash-flow would not be able to cover its debt repayments and the required capital works costs. It was also thought that competitive rail access reforms, expected to be introduced in 2000, would decrease the value of the business as an asset on the market. The government concluded that a rapid disposal of the business and assets would maximise the return to the State, and that private enterprise investment in the rail freight business would introduce efficiencies and growth.

Initially the government had sought to sell both the Westrail freight carrying business and the rail network infrastructure. However, after analysis of all possible sale and lease options the State found that selling the freight carriage business while leasing out the rail network was the best option. This arrangement was intended to allow the State to:

- obtain a good price
- retain ultimate control over the track standard, capacity, and service continuity, in the public interest.

The sale and lease enabled the government to step back from the day-to-day operation of the rail freight network, allowing the new private sector operator the opportunity to provide the innovation, operating efficiencies and growth envisaged by the State. At the same time, the proposed lease arrangements would provide the State with scope to manage the lease to protect the State against a number of retained risks and liabilities.

The government considered that the terms of a lease could provide a range of safeguards for the State, protecting the condition of the network, and allowing the government to continue to invest in the network to serve the public interest. Importantly, a lease could include agreed procedures for withdrawing marginal lines from use, or alternatively providing government support to keep marginal lines operating, depending on prevailing government policy. Government viewed the long-term lease arrangements as reducing risk to the state by retaining 'step in' rights for the State in limited circumstances, while providing flexibility and certainty for private sector operators.

The Western Australian Parliament gave the government of the day the authority to put its policy into effect through the passing of the *Rail Freight System Act 2000*. The Act allowed for the disposal of the rail assets, but also imposed some restrictions, including that the rail corridor land could be leased but not sold.

Development of the sale and lease of the rail freight network

The government formed a Rail Freight Sale Taskforce to deliver a rail freight sale and lease as one single vertically-integrated tender process. The Taskforce was established by Cabinet, and advised Cabinet on the sale and lease arrangements.

The Taskforce had access to analysis and advice from the public sector and external consultants, lawyers, auditors and financial advisers. Its purpose was to manage the sale and lease of the Westrail freight system to optimise the financial return to the State, while also promoting the State's strategic needs and objectives.

Following a public tender process, the State government leased out the rail freight network (including the rail, sleepers and signals and corridor land) in December 2000 for 49 years. With the sale of the rolling stock (wagons and locomotives) taking place at the same time, the State's entire rail freight system, Westrail Freight, was disposed of for a total of $586.7 million. Of this, $292.5 million was for prepaid rent for the lease of the network over the 49 years. The buyer and lessee was the Australian Railroad Group Pty Ltd (ARG). ARG was a vertically integrated railway company, with subsidiaries carrying out both freight carriage and track management business activities, and was a joint venture between WA-based Wesfarmers and US-based Genesee & Wyoming Inc. The ARG business traded as WestNet Rail an Australian-based company.

In 2006 ARG was sold to a consortium comprising the Australian company Babcock & Brown Infrastructure and Queensland Rail (QR). The lease of the rail network went to Babcock & Brown (and others) for $835.5 million, who continued to trade as WestNet Rail. The above-rail assets went to Queensland Rail.

The division of the freight carriage and network infrastructure parts of the rail freight business diverged from the 'vertically integrated' model chosen by the sale and lease Taskforce. This change meant that the lessee of the rail network no longer received profit from related entities carrying freight over those lines. As a result, it became less attractive to continue operating some lines.

In 2009 Babcock & Brown Infrastructure became Prime Infrastructure when parent company Babcock and Brown was facing bankruptcy. In August 2010 Prime merged with Brookfield Infrastructure, a limited partnership with world-wide investments in infrastructure assets. In 2011 WestNet Rail started operating as Brookfield Rail, and is currently wholly owned by Brookfield Infrastructure.

How the State's interests are protected

The involvement of experienced commercial bodies in the rail freight network facilitates the efficient allocation of resources and broadly aligns the interests of the lessee and the State. Occasionally the interests of the State and the lessee will diverge. An independent regulatory regime, the authorising Act, and the lease itself provide means for the State to manage these risks, while also protecting the commercial interests of the lessee.

Regulation of privatised rail freight

The intended privatisation of the freight rail network by lease was supported by a regulatory structure to prevent the abuse of monopoly positions in the market, to guarantee that all freight carriers could use the network at fair prices, and to ensure the safe operation of the network.

The State Rail Access Regulator was established in 1999–2000 to regulate rail access. This role was subsumed by the independent Economic Regulation Authority (ERA) in January 2004, which regulates the pricing of rail access under the *Railways (Access) Act 1998*. The ERA oversees rail freight network access and pricing arrangements under the Railways (Access) Code 2000, with the aim of guaranteeing all rail users (including potential competitors of the lessee) access to the entire network at a fair price. All freight rail carriers on the State's network have opted to negotiate their own access and pricing arrangements with the lessee, rather than take the price determined by ERA. The ERA is also responsible for monitoring whether the lessee makes key information relating to the rail freight network available for public purchase.

A *Rail Safety Act* was first passed in 1998 to ensure that private rail network operators such as the lessee would establish and implement an appropriate safety management system for the use of the network. The Office of Rail Safety (ORS) accredits the lessee under this Act and monitors compliance with safety management systems. The ORS is a self-funded independent regulator, but operates as a business unit within the Department of Transport. The focus under the *Rail Safety Act* is whether the lessee is managing the network to ensure that trains are travelling safely, rather than whether the network is being maintained in a 'fit for purpose' state as required by the lease. Safety issues can frequently be addressed by the lessee imposing speed restrictions on the affected line.

The authorising Act imposed some restrictions on the privatisation

Parliament imposed some restrictions on the privatisation of the rail freight business and network in the *Rail Freight System Act 2000*. Most fundamentally, the Act stated that the rail network could be leased, but not sold, and certain key freight lines could never be surrendered from the lease. Two additional restrictions were imposed during debate in Parliament, requiring upgrades to certain lines.

The lease aims to keep the network 'fit for purpose'

The lease requires the lessee to maintain, replace, repair, and upgrade the rail freight network so that it is 'fit for purpose' during the lease and at the conclusion of the lease. 'Fit for purpose' means that the network:

- meets the requirements of rail users
- meets requirements in the *Rail Freight System Act 2000*
- complies with the *Rail Safety Act 2010*.

To avoid uncertainty, the lease includes a schedule that sets out in technical detail the minimum 'performance standards' required for each section of rail to meet this broad 'fit for purpose' definition. This schedule describes the capacity of sections of the rail network to carry trains of certain weights, speeds, and lengths. The weight of the rail and the type of sleepers and ballast are also specified.

The lease enables the network to adapt to changing demand and new technology by allowing the performance standards to be updated by agreement every five years, or when there is a material change in circumstances, based on an expert review. Performance standards can be raised or lowered wherever the State and the lessee agree that new standards are required to meet the requirements of rail users and remain in step with changes in rail technology.

If proposed changes are not agreed, then a dispute resolution process established under the lease may be used, which concludes with binding arbitration if necessary.

PTA is empowered to monitor and ensure compliance by the lessee

The lease enables PTA to monitor the lessee's compliance with the lease, to ensure the State's asset is maintained in a fit for purpose condition. The lease requires the lessee to provide PTA with five-yearly independent network condition reports, followed by maintenance plans that address issues raised in the condition reports. PTA may also seek evidence from the lessee that planned maintenance has been satisfactorily completed.

Under the lease, the lessee must:

- provide PTA with a five-yearly independent review of the condition of the network to ensure that it is fit for purpose, at least 12 months before each five year anniversary of the lease
- submit five year maintenance plans that i) address the issues identified in the above network condition report and ii) show the works, repairs, replacements and maintenance required for each year to keep the network fit for purpose. This maintenance plan is to be submitted to PTA within six months of the independent network condition report
- submit plans and drawings of any material works the lessee has completed, or intends to complete, to maintain the lines to their specified and agreed performance standard
- inform PTA immediately following any continuous period of three months of non-compliance with any performance standard

- submit annual 'corridor reports' which should provide detailed information on the use of the network and certify that performance standards have been complied with
- submit to dispute resolution mechanisms, including arbitration if agreement cannot be reached on any matter concerning the lease.

The lease provides financial and legal consequences for non-compliance by the lessee, creating a commercial incentive for the lessee to meet its obligations. The lessee must pay $20 000 for each day that the leased railway infrastructure is not 'fit for purpose', or a fee of $1 million if the lessee does not submit a maintenance plan. The lessee faces the possible termination of the lease if the lessee fails to maintain, replace, repair or upgrade the infrastructure so that it is fit for purpose.

The lease sets up a process to deal with low-traffic marginal lines in the State's interests

The lease was designed to use competitive market forces to deliver the best possible rail freight network, while leaving the policy decision to either subsidise or shut down marginal lines in the hands of the State.

At the time of drafting the lease, the State recognised that some narrow gauge grain lines would be unlikely to operate profitably for the lessee, particularly in low-harvest years. Pure commercial incentives would call for the early closure of these lines, to maximise the profit made from the network as a whole.

To avoid the unplanned deterioration of these marginal parts of the network, the lease sought to ensure that the operator of the standard gauge track would have 'a financial or legal interest in the continued maintenance and operation of the narrow gauge track', to the extent that this remained government policy. The lease achieves this 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.

The 'surrender' option allows the State to use free market competition to find a more efficient operator for marginal lines. Where the State wishes to avoid the lessee surrendering a low-traffic uneconomic line, government may agree to provide support or funding, or to make other arrangements to enable the lessee to continue maintaining and operating lines which would otherwise not be economically viable.

To benefit from these provisions, the lessee must first prove that the lines in question are indeed eligible low-traffic uneconomic lines. From December 2006 the lease allowed the lessee to request State funding or allow it to surrender lines, if two conditions were met:

- in the preceding financial year, the line carried less than 200 000 net tonnes of freight traffic, or otherwise suffered a significant reduction in use (annual freight carried over the line was less than half of the preceding three years' annual average)
- the line is expected to return a loss for the lessee over the following three years, once the cost of maintaining the line in a 'fit for purpose' state is taken into account.

The lessee is not permitted to surrender the rail lines between Perth-Geraldton, Perth-Bunbury, Brunswick-Collie, Kwinana-Kalgoorlie, Kalgoorlie-Esperance, or Kalgoorlie-Leonora, which carry significant freight volumes. Parliament retains ultimate legal control over the network, because rail corridors may only be formally closed by Parliament. Unless Parliament removes a corridor from the network, all of the land covered by the lease and designated as a rail corridor will continue to form part of the rail freight network. The rail corridor continues to exist, even if the rail lines, sleepers and ballast are not maintained, in use, or even physically present.

Government policy on marginal grain lines

To make best use of these flexible mechanisms in the lease, PTA has obtained expert policy analysis and advice on a number of occasions since 2007 (see Appendix 1). The advice concerns which of the low-traffic uneconomic lines should be kept open using State funding or 'other arrangements', or surrendered from the lease and offered again to the market, or withdrawn from service. Based on this advice, government policy on the grain lines has evolved over time.

Examining the strategic policy decisions around the low-traffic uneconomic lines is outside the scope of this audit. Instead, this report focuses on whether PTA and Transport have effectively managed the lease by analysing available options under the lease, and advising government on the risks of departing from the lease structure.

The history of government policy on the grain lines provides valuable context for understanding the decisions taken by PTA and government in managing the lease. In some cases government decisions have departed from the lease framework in order to attain policy objectives. The table in Appendix 1 summarises key milestones in the development of government policy regarding the grain freight network, as background information.

The agencies managing the lease

The PTA is the primary agency responsible for managing the rail freight network lease. PTA was established in July 2003, combining the residual functions of the former Western Australian Government Railways Commission, while also carrying responsibility for Transperth, School Bus Services and local regional bus services, all previously operating under the Department of Planning and Infrastructure. PTA was created to consolidate the delivery of public transport within one agency, and its Annual Report 2010–11 demonstrates that public transport remained its main focus at the time of this audit. For simplicity, this report uses 'PTA' to also include the Western Australian Government Railways Commission prior to 2003.

Transport manages long-term transport planning, including rail freight infrastructure, determining future needs and investment priorities for rail freight transport. Transport's strategic planning and 'whole-of-portfolio' oversight role overlaps with PTA's responsibilities, especially where these concern longer term objectives and critical transport infrastructure. PTA is required to work closely with Transport to ensure that the management of the 49 year lease serves the long-term strategic transport infrastructure objectives of the State. Since May 2010, the Director General of Transport also leads PTA and Main Roads WA, with the aim of introducing a more cohesive, integrated approach to the planning, investment and operation of WA's transport system.

This audit primarily focuses on the role of PTA as the government agency that 'owns' the Freight Rail Network on behalf of the State, and that manages the lease to protect the State's interests. Transport's planning, coordination and investment prioritisation role supports PTA in fulfilling this responsibility. The roles of the ORS and the ERA are not included in this audit.

Many of the original objectives for the lease of the network have been met

The Sale Taskforce reported that the immediate objectives for the sale and lease were met

A Rail Freight Sale Taskforce was established as a committee of Cabinet to manage the sale and lease of the Westrail freight business and network. In 1999 Cabinet approved four principal objectives for the sale and lease of the freight rail system:

- securing a purchaser who will introduce innovation and operating efficiencies, grow the business, both in Western Australia and elsewhere and invest in the business (both 'above' and 'below' rail assets)
- ensuring a fair resolution of all staff issues
- ensuring only legitimate risks and liabilities related to the rail freight industry in Western Australia are retained by government, and that these would be minimised
- obtaining the best possible price consistent with the achievement of other sale objectives.

Eighteen months after the sale and lease were agreed, the Taskforce presented a final report to government, concluding that these objectives had been achieved.

The Taskforce documents indicate that government decided to lease the rail network infrastructure in order to retain ultimate control over this strategic asset. The text of the lease indicates that government had two long-term operational objectives concerning the management of the rail freight network:

- preserving the State's flexibility to continue to invest in the rail freight network or even resume management of parts of it, should it see the need, as evidenced by the lease recitals and provisions relating to the surrender of uneconomic lines
- maintaining a direct interest in the ongoing condition of the freight rail network itself, as evidenced by the lease recitals and provisions relating to maintenance reports, maintenance plans, and the revision of performance standards.

The sale and lease reduced State debt, and removed government from the freight rail business, but the State has continued to provide funding for the network

Through the lease of the rail freight network and by selling Westrail, the State was intentionally stepping back from direct involvement in the business of rail freight, and seeking an immediate financial return from the sale and lease of the assets.

The proceeds from the up-front rent payment for the lease allowed the State to reduce debt. The competitive tender process resulted in a total bid of $586.7 million for Westrail Freight, including the sale of the above rail business and an upfront payment for the lease of the network. The lessee paid the 49 year rent of $292.5 million (excluding GST) at the time of entering into the lease – equating to a fixed yearly 'rent' of just under $6 million. Five hundred million of the sale and lease proceeds were used to reduce Westrail's $700 million debt to the WA Treasury Corporation.

As the State no longer operates the rail freight business, it does not meet the day to day costs of running the network. However, the State remains responsible for the cost of works undertaken in the public interest, which the lessee would not necessarily undertake in its own commercial interest. This potential liability was recognised by government when leasing the network, but no estimate was made of the likely amount of these required investments.

PTA records show that, between 2000 and 2011, State and Commonwealth funding spent or committed to the leased network totalled around $360 million. Around $102 million of this has been contributed by the State, and $258 million from the Commonwealth (see Table 1). Commonwealth funding is provided in recognition that parts of the State's rail freight network form a significant and strategic component of the national transport infrastructure system.

Because the State's expectations of its future capital investment and maintenance costs were not quantified at the time of the lease, or in the years following, we are unable to conclude whether this level of expenditure is in line with the original objective that only 'legitimate risks and liabilities' would be retained by the State, and that these would be minimised.

Project	Year	Description	Expenditure	Comment
Geraldton Southern Rail Corridor	2000–01	New access to Port	PTA – $52.2 m	Relocation of the Narngulu/Geraldton Port Line to a southern rail corridor. These works were anticipated at the time of the lease.
Albany spur	2005	Construction of a spur	PTA – $1 m	Construction of a track to service a woodchip mill, connecting to the Avon-Albany line. Originally constructed at the lessee's cost and purchased by government. This work was already underway at the time of the lease.
Eastern Goldfields Railway project 2007	2007	Crossing loops, replacement of sleepers and line strengthen	PTA – $9 m Commonwealth – $28.1 m [Above rail operator – $2.4 m and up to $21.8 m payable by Lessee]	These works have allowed faster running of the Indian-Pacific and Prospector passenger trains, and also of all freight trains on this line. (PTA is currently seeking Commonwealth approval to redirect $1.2 m savings in Commonwealth funding towards the Grain Freight Network upgrade)
Grain Freight Network	2011–13	Replacement of sleepers and maintenance on the line to be completed by June 2013	PTA – $36.4 m Commonwealth – $135 m [Lessee – $16.5 m]	The grain network is categorised into three tiers. Funding is available for re-sleepering from 1:4 steel to 1:2 for Tiers 1 and 2. Tier 3 lines to be withdrawn from use. The Lessee expenditure is in place of outstanding commitments under the lease on the grain line strengthening plan. $13.5m of PTA funding is redirected from the Greenbushes Rail Project.
Tier 3 Grain Lines	2011–12	Reopening lines for 2011–2012 grain harvest	PTA – $3.3 m	Due to delays in completion of road upgrades to allow greater usage
Eastern Goldfields Railway project 2011	2011	Two new passing loops and new rail tracks between Koolyanobbing and Kalgoorlie	Commonwealth – $95 m	
			Total Government expenditure = $360.2 m	

Source: PTA and OAG

Table 1: State and Commonwealth funding for the rail freight network up to June 2011

Funding for the network has also been provided by other government departments, for example Main Roads, for the Esperance Port Access Transport Corridor, but this is not shown in the table. The table does not include the cost to the State of a $14.6m 'transitional assistance package' announced on 15 November 2010 designed to subsidise the cost to freight handlers of keeping grain on rail from 2010–11 to 2014–15.

The lessee and private parties are also making significant contributions. For example in 2011, Karara Mining Limited was providing $300 million in security for the lessee to undertake a $450 million rail upgrade of the line from Morawa to Geraldton. The lessee also reported in 2011 that it was partnering with Cliffs Natural Resources for a $200 million upgrade of the rail infrastructure between Kalgoorlie and Esperance to transport exports from Cliffs' iron ore operation in Koolyanobbing through Esperance Port.

Freight volumes have increased and the condition of standard gauge lines has improved, but narrow gauge lines have degraded

The State sought private sector involvement in the rail freight network to create innovation, investment, efficiencies, and growth in the network. The amount of freight on the rail network overall has increased substantially since the network was leased out in 2000, and the commercial incentives of the lessee have resulted in significant improvements to parts of the network. The standard gauge lines have improved, as have those narrow gauge lines used primarily for carrying minerals, but the condition of the lower traffic less profitable narrow gauge lines used primarily for grain has deteriorated, due to the delayed replacement of sleepers on these lines.

By 2009, the network was carrying 54.4 million net tonnes of freight, almost 70 per cent more than in 2000. The lessee expects that freight will grow to 85 million net tonnes by 2013 – more than two and a half times the volume carried in 1999 when the lease was planned.

This growth has been concentrated on the mineral and general freight carrying lines, comprising 1 695 kilometres, or 30 per cent of the network by length, but carrying 73 per cent of the network's total freight tonnage.

Mineral and container freight carrying lines have expanded and been upgraded over the last decade, with significant lines operating at better performance standards than specified in the original lease, according to the 2010 track condition report commissioned by the lessee and accepted by PTA.

These improvements mean that maximum train speeds and weight have increased, resulting in more freight being carried on these lines.

The condition of lines used primarily for transporting grain has degraded. The 'Grain Line Strengthening Plan' (GLSP) commenced by government in 1996 and integrated into the lease was intended to prolong the life of these lines until the mid-2000s, by inserting steel sleepers for every fourth wooden sleeper. However, the GLSP was an interim measure, and could not take the place of the comprehensive cyclical re-sleepering works requiring significant investment. An independent review in 2009 found that 23 of the 29 grain lines would be regarded as unfit for purpose unless these major re-sleepering works were carried out.

PTA reached an agreement in July 2010 that without government funding for re-sleepering, 67 per cent of the grain network (1 450 kilometres of track including nine Tier 1 and 2 lines) would be placed in care and maintenance by 2013–14, and 90 per cent of grain lines would drop below their original December 2000 condition. In keeping with the 2009 Strategic Grain Network Committee review government is funding the required works on Tier 1 and 2 grain lines, but not the works on Tier 3 lines. Some of the funding was approved before the agreement was signed.

To date, two Tier 3 lines have been placed in care and maintenance, and government provided funding of $3.3 million for maintenance works to keep four Tier 3 lines open until the end of October 2012. The lessee will keep these lines open until the end of October 2013, without additional government funding. Under the 2010 agreement, without further funding after October 2013, the Tier 3 lines can be placed in care and maintenance.

All lines in service must be operated safely under the regulatory regime supervised by the ORS. The grain lines have continued to be safe for use but this requires the imposition of speed restrictions, and in the case of some marginal lines, the restriction of rail traffic to the night hours when the rails are cooler and therefore more stable.

Government policy on the grain lines has changed over time. Government deferred the completion of the GLSP from 2004 to 2008, and in 2010 removed some of the original GLSP requirements under the lease as no longer reflecting policy following the Strategic Grain Network Committee Review in 2009.

PTA and Transport advise that, as reflected in the Strategic Grain Network Committee Review, the declining use of the grain network and its deteriorating state has been due to market forces shifting the grain freight task from rail to road, and not due to delayed maintenance of the network. According to PTA and Transport, many farmers have found it cheaper to transport grain by road than by rail. PTA and Transport advise that trucks carrying grain by road do not meet the full costs of the construction and maintenance of the roads. A proportion of these costs are subsidised indirectly by the public through general government spending on the road network, and these costs are not fully recovered from truck freight operators. In comparison, freight carried by rail must meet the full cost of the maintenance and construction of the rail for the rail line to remain profitable.

PTA advised that the transition from the 'single desk' Australian Wheat Board market structure to a deregulated wheat market in 2008 adversely affected the grain lines. As a result of the newly deregulated environment, in 2009–2010 Cooperative Bulk Handling (CBH) began withdrawing the 'cross-subsidisation' of the storage and transport of grain in marginal areas. CBH had previously charged the same price per tonne of wheat for all locations, regardless of the distance the wheat was carried. This change increased the cost of transporting grain by rail from more remote agricultural districts, creating pressure for the grain freight task to move from rail to road in these areas.

In PTA's view, the movement of grain freight from rail to road was inevitable without government intervention, and very difficult to reverse once established. The original grain lines were constructed in the late 1800s and early 1900s, prior to the construction of more direct high-speed road routes. Both the 2008 Grain Infrastructure Group and the 2009 Strategic Grain Network Committee acknowledge that in some regions road transport offers a more cost effective way for individual farmers to deliver grain to the nearest port for export

Analysing the competitive efficiency of road or rail freight transport is outside the scope of this audit.

A change in lessee in 2006 made more lines potentially eligible for State funding

The 2006 sale of the then lessee ARG led to the commercial separation of the rail freight network lease from the freight carriage business. These related activities had previously been linked through ARG's corporate structure. ARG was the parent company of two wholly-owned subsidiaries operating a freight carriage business and a network operator business. This corporate structure allowed revenue from freight contracts to be taken into account when assessing whether a line should be regarded as uneconomic under the lease. Once these two businesses were separated, the lessee received only the revenue associated with the rail freight network lease itself.

This reduced revenue stream meant that some marginally profitable low-traffic lines were more likely to become technically 'uneconomic' under the lease, and therefore eligible for government support, or possible surrender from the lease. By 2007 the lessee had approached the State government seeking to surrender certain uneconomic lines under the lease, or to obtain State funding to cover losses.

This led to a series of reviews of the viability of the grain network, culminating in the December 2009 recommendations of the Strategic Grain Network Committee review (see Appendix 1). The Committee's recommendations were reflected in a July 2010 project agreement in which the State agreed that unless State funding was provided for re-sleepering up to two thirds of the grain lines would be progressively withdrawn from use by 2013–14. Government has subsequently approved funding for works on Tier 1 and 2 lines, but not works on the Tier 3 lines.

Some conditions in the *Rail Freight System Act 2000* have not been met

Under the *Rail Freight System Act 2000* (the Act), Parliament required any future lessee to complete two upgrade projects, as a condition of authorising the sale and lease. The Act required that once the upgrades were completed, the upgraded condition must be maintained over the term of the lease. PTA found the first of Parliament's required projects to be unenforceable. The second project has been completed, but the upgraded standard of the track has not yet been reflected in changes to the lease performance standards.

The Act firstly required the lessee to upgrade the Koolyanobbing-Kalgoorlie-Esperance line within two years of there being a contract with the holder of the land (the lessee) for more than three million tonnes of freight to be carried on the line. PTA could not enforce this requirement, because the Act's threshold is legally unclear. The Act refers to a contract to carry freight 'with the holder of the land', (denoting the lessee), which conflicts with another part of the Act that prevents the lessee entering into a contract to carry freight. This means that this threshold will never be triggered. Even without this problem, the Act's threshold of a single contract for three million tonnes is unlikely to be met and the condition triggered.

PTA has not monitored when the level of freight passed three million tonnes, and the lessee has not been required to undertake the works. The lessee nonetheless began upgrade works in 2008 on its own initiative, under an agreement with a private partner. Available evidence indicates that more than three million tonnes of freight was being carried on this line by sometime between 2002 and early 2004, but PTA advise that there has never been a single contract for more than three million tonnes carried on this line, as expressed in the Act.

The Act also required the lessee to upgrade the Parkeston (Kalgoorlie)–Kwinana line in accordance with any program developed by the holder of the land in cooperation with the Australian Rail Track Corporation (ARTC). These upgrade works were completed in 2010, and the standards specified in the Act apply. The lease performance standards have not yet been amended to reflect the improved standards as specified in the Act.

Parliament has had limited information on the lease

Parliament has had limited information regarding the condition of the network, partly because PTA is bound by a broad confidentiality clause in the lease, and partly because little information is required to be or has been made public by the other agencies with regulatory responsibilities in this area. Although Parliament has been partially informed about lease terms and conditions through various Ministerial statements, a full copy of the lease and subsequent agreements modifying the lease has never been tabled in Parliament, and only the first five-yearly track condition report in 2005 has been tabled.

Transport and PTA are aware that the Minister may table the lease in Parliament, or provide it to individual Members of Parliament, but maintain the view that Transport and PTA are bound by the confidentiality provisions of the lease. In 2011 PTA opposed a request for lease information and the five-yearly track condition reports from a third party, on the grounds that the lease was confidential. PTA's view was upheld by the Information Commissioner.

While maintaining this wide view of the lease's confidentiality, PTA has advised its Minister on two occasions that it sees no obstruction to the Minister tabling the lease in Parliament. The lease contains a widely-drafted confidentiality clause that asserts that the entire lease and all related documents should be treated as commercially confidential, while also authorising the tabling of the lease in Parliament, or the provision of the lease to Members of Parliament on request. Despite not having been tabled in the Western Australian Parliament, we found that the text of the original lease is now available on the internet through an overseas provider.

The fact that the Taskforce that set up the sale and lease in 2000 was established as a Committee of Cabinet has restricted access to some information. We note that Ministerial requests for information in 2007 and 2008 were declined because the Taskforce's key documents and deliberations were considered subject to Cabinet confidentiality.

One government regulatory agency has published limited information on the state of the rail freight network. Until 2006–07, the ERA published key performance indicators (KPI) on the performance of the rail freight network. It stopped doing so because it formed the view that its legislation did not allow it. As a result, the ERA has removed the KPI reporting obligation from the lessee's compliance requirements.

Although the 2010 five-yearly track condition report has not been tabled in Parliament, the lessee is obliged under the Railways (Access) Code 2000 to make key rail network information publicly available for purchase. ERA is responsible for monitoring compliance with this obligation, which includes information regarding section running times, permanent and temporary speed restrictions, gross and net freight volumes by line for the past three calendar years, and available capacity.

The ERA has determined maximum recoverable costs for rail access, although these limits do not reflect the actual prices paid by freight carriers to use the network. This is because all freight rail carriers on the State's network have opted to negotiate their own access arrangements with the lessee, rather than relying on the limits determined by ERA

A $400 million investment commitment by the successful bidder was not included in the lease

A range of documents state that the successful bid included a proposal by the bidder to spend $400 million in capital investment during the first five years of the lease. A number of these documents confirm that this commitment was never included in the final lease contract or other binding agreement. However, none of the documents that we have reviewed provide an explanation of why the proposal was not included in the final contract, and this remains unclear.

Because the proposal was not included in the final lease contract, PTA did not monitor its implementation. PTA have informed us that over $2 billion has been invested in the network by the lessees since the start of the lease.

A risk-based contract management plan would help protect the State's interests over the remaining thirty-seven years of the lease

Because the rail freight network is a key infrastructure asset owned by the State, government continues to face a range of inherent risks. The lease contains sophisticated mechanisms to enable the State to manage risks. The lease relies on market forces to drive the lessee's investment in profit-making lines, while also allowing the State to ensure the lessee continues maintaining and operating the less profitable parts of the network, to the standard the government wants, and potentially funded by government.

Key areas of apparent or emerging risk include the use of the performance standards and 'fit for purpose' requirements, dealing with uneconomic lines, monitoring the lessee's maintenance of the network, and end of lease issues.

The level of contingent complexity in managing a long-term lease in a dynamic and changing environment calls for a risk-sensitive management framework. Such a framework would allow PTA to clearly identify the State's interests and objectives, identify emerging risks, plan to monitor and address them, and demonstrate that it has considered all options.

PTA has not yet conducted a structured risk assessment of the lease and does not have a contract management plan in place

While PTA has had processes in place to manage the lease, it has not put a contract management plan in place based on a structured risk assessment of the lease. The State Supply Commission currently requires that a contract management plan be developed for all procurements with a value of $5 million or more. The replacement value of the Rail Freight Network is $5 billion. PTA began preparing a contract management plan in 2012, partly in response to this audit, and has sought legal and consulting advice regarding key elements of the lease. PTA advised that this plan should be finalised in the final quarter of 2012.

The absence of a contract management plan and risk analysis does not mean that the lease is not being managed or that the State's interests are not being protected. It does, however, mean the State's objectives and interests may not be clearly defined, increasing the risk that emerging issues may not be identified and that issues may be resolved reactively and not in a way that supports the State's longer term interests.

A risk analysis underpinning a contract management plan would help PTA target its resources to monitoring only key aspects of the lease and to maintain a light touch in managing the lease. Likely areas where a risk based approach would focus would be:

- the five-yearly condition reviews to ensure the asset is maintained in an appropriate way
- the monitoring and reporting regime for activity and investment on the network
- the increasing risk of the parties' interests diverging in the latter part of the lease term
- the management of low-traffic lines that could potentially be uneconomic
- those lines receiving State funding.

A contract management plan should provide PTA and Transport with a clearly structured method of responding to a highly dynamic market and policy environment using the sophisticated mechanisms contained in the lease. The plan will enable PTA to identify and document those instances where policy considerations dictate moving outside the lease.

Compliance with an appropriate contract management plan will allow PTA to readily demonstrate that key risks have been identified and are being managed proactively. A risk-oriented contract management plan links changes in market conditions and government policy to the lease, and clarifies ambiguities in the interpretation of the lease.

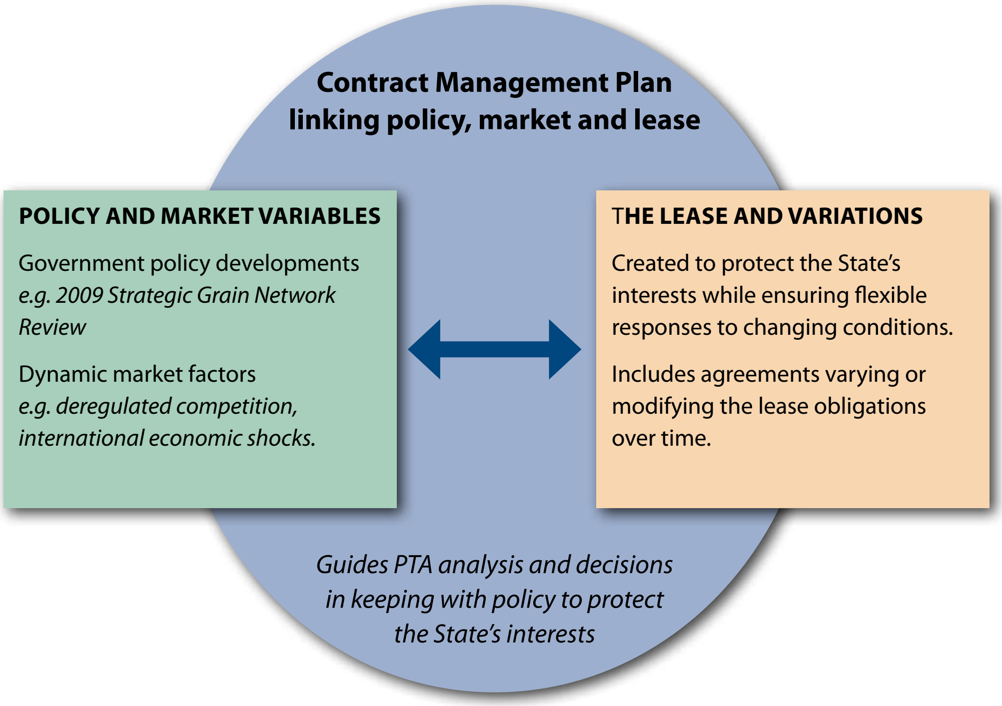


Figure 2: A risk-sensitive contract management plan provides PTA with the means to link dynamic policy and market conditions with the rail freight network lease, while protecting the State's long-term interests

At its highest level, this contract management plan should integrate with the State's transport policy objectives developed by Transport. At a more detailed level, the plan would also establish procedures for applying the lease terms, and guide decision making at key 'trigger' points, such as when the operator seeks government funding for network expansion or when it seeks to surrender non-economic lines. The plan should reflect a considered risk-based approach, focusing attention on key risks identified by a thorough analysis. This kind of plan would assist the State to identify opportunities to maximise benefits from the lease, and to avoid the realisation of risks. Lessons learnt in other Australian jurisdictions could inform the development of the plan, ensuring that PTA's assumptions regarding risk are tested by an informed, external and impartial party.

Underlying risks should be regularly re-assessed using early-warning and risk detection approaches to ensure a proactive response to key strategic risks. The State could suffer significant financial loss if some risks surrounding the lease of the rail freight network materialised. For example, if sections of the rail freight network deteriorate below a standard that is useable, the government may need to inject significant additional funds into the network, or into alternative freight infrastructure. There are examples in other jurisdictions where rail freight assets have had to be 'bought back' because they were degrading and the lease arrangements did not facilitate the government's policy objectives, and works on the network.

The meaning of 'fit for purpose' and the intended use of performance standards need to be clarified to reduce risk to the State

In order to ensure the network is maintained and handed back in an appropriate condition the lease requires the lessee to maintain and upgrade the network so that it continues to meet the requirements of rail users and keeps pace with technological change over the term of the lease. The lease describes this as 'fit for purpose'. However, there are no objective and external design standards to describe what kind of rail line will 'meet the requirements of rail users' or match contemporary standards of technology.

The lease therefore provides a detailed schedule of technical 'performance standards' for each section of track. This performance standard schedule specifies the weight, length and speed of trains that the track must be capable of carrying, as well as the type of ballast, sleeper and rail installed on each section of line. These standards reflect the state of the network when it was leased in 2000. The lease anticipates that the performance standards should be updated by agreement, or by expert determination if necessary, every five years or as circumstances require.

There are a number of possible interpretations of 'fit for purpose' and how the accompanying performance standards should be applied and updated. PTA has interpreted the lease narrowly, concluding that in the majority of cases the only usable standards are the Initial Performance Standards, set at year 2000 levels. If these form the only basis for driving the maintenance of the network, then this risks the network being returned in 2049 in the same condition it was in 2000.

The initial performance standards have been changed in two instances since December 2000 – one where the State funded improvement works, and one to lower the standards to place lines into care and maintenance. However, the lease anticipates a review of performance standards every five years across the network, seeking to ensure that the standards remain in step with market needs and changing technology.

The performance standards can be changed by agreement to either increase or reduce them every five years or ad hoc when circumstances change. The standards can be reduced to reflect reducing demand for the line or to place a line into 'care and maintenance'. The standards would be increased to ensure that investment in and improvements to the network become part of the baseline and the improved condition is maintained for as long as this is required by rail users. Where agreement cannot be reached, the lease provides for an arbitration process.

The five-yearly or ad hoc review of performance standards mechanism ensures that the network lessee can adapt the network to meet the changing market, while the State retains the ability to protect the public interest by keeping the performance standards up to date. It is important that the standards are reviewed and changed when appropriate. However, changing the performance standards has proved problematic and the December 2000 performance standards continue to apply for most of the network.

The 2005 independent track condition report called for performance standards to be revised in a number of cases where the standard of lines had been improved since 2000, and specifically recommended that a new set of performance standards be in place for the next review in 2010. The performance standards were not comprehensively reviewed and the 2010 review of the condition of the mineral carrying lines was made against the original standards.

PTA considered the recommendation, but formed the view that the lessee would not agree to improved performance standards without also requiring additional funding or some other concession from the State. There was no evidence that this had triggered any structured analysis or consideration of the broader issue of how to implement the lease mechanism for five-yearly review of the performance standards.

Lowering the standards is more likely to be readily agreed, in part because it is likely to relate to uneconomic lines and potentially reduces both the State's and lessee's maintenance costs. Raising the performance standards, without an objective independent set of standards to define 'fit for purpose', is likely to be more problematic. It is relatively simple for the State to require an increase in the performance standards where it has funded improvement works. However, where the improvements have not been funded by the State then reaching agreement is likely to require some commercial or financial consideration or benefit from the State to the lessee. PTA considers that it in most cases lacks the commercial incentives that would enable it to obtain the lessee's agreement.

Based on internal legal advice, PTA has interpreted the lease such that in most situations the only usable standards are the Initial Performance Standards, set at year 2000 levels. This is a substantial reduction of the broad 'fit for purpose' obligation, as it does not include the requirement to meet the needs of rail users or reflect changes in rail technology. This presents the risk that the expectation in the lease that the performance standards should be updated to ensure the network meets the needs of rail users and keeps pace with technological change will not be met. It relies on commercial incentives to ensure that lessee meets the needs of its users.

While we appreciate that this approach has so far been effective in improving the condition of the standard gauge network, without regular reviews and updating of the performance standards the five-yearly track condition reports will continue to assess the network against out-dated criteria, and the lessee will be under no legal obligation to maintain the network to its currently improved standard.

We understand that the absence of independent criteria to define 'fit for purpose', and the setting of the lease performance standards at year 2000 levels, leaves PTA in a difficult situation. However, there is a need to resolve how standards can be adjusted and what fit for purpose means. Putting in place a full contract management plan to make these issues and the State's objectives explicit would provide the basis for reaching an understanding with the lessee.

PTA reviews network condition and maintenance every five years; more frequent monitoring would better match the risks on some lines

The lessee is required to provide PTA with evidence of maintenance planned and conducted so that PTA can ensure that the network is kept fit for purpose. PTA comprehensively review maintenance of the network once every five years, using the track condition report required under the lease, and this includes maintenance plans for the coming five years. However, implementation of the maintenance plan is not consistently tracked or reviewed until the next five year review.

This five year period between reviews is appropriate for much of the network where component lifecycles and maintenance cycles are relatively long. For these lines whether maintenance is conducted in a specific year or the following year is unlikely to have a significant impact.

However, for other areas of the network, for instance lines at risk of becoming 'uneconomic', those lines receiving government funding for maintenance, or lines requiring major infrastructure renewal, more frequent monitoring could be more appropriate to ensure maintenance is completed as planned. In these cases, deferral or bringing forward maintenance can have an impact on costs to the State.

For instance, if a line qualifies as 'uneconomic' due to maintenance costs outstripping revenue, the lessee can request that the State fund the maintenance of that line, or withdraw it from service. If maintenance consolidates into the three year period over which the viability of a line is assessed, this can make a line appear unprofitable. PTA can manage this risk by ensuring the maintenance plans spread the required works over an appropriate period and that the plan is implemented as planned. This requires a process for more frequent tracking of maintenance progress for certain lines, which PTA does not currently have in place.

There have been inconsistencies in reports to PTA, and gaps in PTA's network information

The lease requires the lessee to report to PTA annually on the gross tonnes of freight carried for each section of line, the number of track kilometres in use, and the number of trains passing over each section of line. The lessee addresses this requirement through annual 'corridor reports' but these do not accurately show how much of the network has been taken out of use by the lessee each year. A number of narrow gauge lines have gone in and out of use, but the lessee's reported length of non-operational track has remained consistent from 2001 to 2011 (at 415.27 km of narrow gauge track). PTA classified two additional lines as non-operational from 2008 (Tambellup-Gnowangerup and Katanning-Nyabing), but this change was not reflected in the lessee's annual report to PTA.

The lessee is obliged to maintain non-rail assets within the rail corridor (including buildings, platforms and storage facilities) to ensure reasonable safety. However, these non-rail assets are not required to be included in the five-yearly network condition reviews, because the assets were omitted from the lease schedule containing the network performance standards. As a result, PTA does not have current information on the condition of these non-rail infrastructure assets inside the rail corridor.

PTA has 'in principle' access to plans and drawings of any major works done on the network by the lessee, which provide a means for PTA to monitor whether those works have been properly completed. These documents also ensure that PTA retains complete technical plans for the network. To date, PTA has not requested these documents from the lessee.

A lack of clarity in how costs should be applied to 'uneconomic' lines risks the State bearing additional costs

Where a line is shown to be 'uneconomic' the State may either fund the maintenance on the line, accept its surrender from the lease, or make other arrangements such as withdrawing the line from service and placing it in care and maintenance. While this allows the State to retain flexibility over how lesser used parts of the network should be managed, and makes the lease a more attractive commercial proposition, all of these options potentially increase the costs to the State. It is important that the mechanisms for deciding that a line is uneconomic are clear. However, there is a lack of clarity about how certain costs should be applied to 'uneconomic' lines, which may lead to additional costs being transferred to the State.

Various methods exist for allocating administrative, overhead, and capital costs to the different lines within the network, but which should be used under the lease is not clear.

An example of this accounting issue is that the lessee has applied the costs of administering the entire network against all lines in proportion to the length and gross tonnage of each line. This means that the administrative costs of the heavily trafficked Eastern Goldfields Railway are borne in part by the marginal grain lines. The lessee estimates that around half the length of its operational network is dedicated to the grain industry, but only 10 per cent of total freight volumes are carried over these grain lines.

An expert review of required maintenance expenditure by KPMG in 2009 questioned whether this cost allocation method fairly reflected the administrative burden of the marginal grain lines. The effect of the method used is that marginal grain lines may become uneconomic and potentially require government funding for maintenance if the government wants the lines to remain operational.

The lease also allows the lessee to include capital expenditure when submitting to PTA that certain lines will be uneconomic to operate. However, the lease does not specify the accounting treatment that should be applied to these capital costs. Normal accounting practice is to depreciate capital costs over the entire useful life of an asset – the years that the asset is expected to deliver economic benefit. Instead of following this practice, PTA has accepted the lessee treating these capital costs as fully expensed in the year(s) they are incurred, rather than over the useful life of the asset. This unusual accounting approach was highlighted by KPMG in its 2009 review, without resolving the issue. This accounting treatment increases the likelihood that a line will be viewed as uneconomic, increasing the risk that costs will shift to the State.

We found no evidence that PTA had sought expert advice on the lessee's methods of cost allocation, or raised the matter with the lessee after KPMG highlighted these concerns. We have recommended to the PTA that this be done.

PTA has varied and adapted its implementation and management of the lease to reflect changing policy objectives on 'grain lines'

The lease created sophisticated and interdependent mechanisms to ensure that the network remains fit for purpose, while also allowing the lessee to pursue its commercial interests and giving the government the flexibility to pursue its policy objectives (see Appendix 1). A key focus of these mechanisms was the management of low and seasonal use narrow gauge lines used primarily for grain haulage, the 'grain lines'.

In some instances, and with government agreement, PTA has varied or adapted the requirements of the lease to reflect a dynamic policy environment on the grain lines. Specifically it agreed to:

- some uneconomic lines being placed into care and maintenance rather than requiring them to be surrendered from the lease
- changes to the obligations of the lessee under the Grain Line Strengthening Plan (GLSP).

While PTA's explanation for these decisions was reasonable, the absence of a structured contract management plan meant that the documentation of PTA's consideration of risks and options was not as extensive as we would have expected. This undermined PTA's capacity to demonstrate that it had enabled government to consider all relevant risks and options in seeking to protect the State's interests.

The introductory recital to the lease shows that the government in 2000 intended to create financial or legal incentives for the future lessee to continue maintaining and operating the marginally profitable narrow gauge lines. Without these incentives in the lease, a prudent lessee would move investment away from the less profitable low-traffic lines and towards the more profitable parts of the network. Over time, the normal operation of these market forces would result in the deterioration and probable closure of marginally profitable or uneconomic lines, and the consolidation of investment in those lines offering the highest profit margin.

The lease created a legal incentive for the lessee to continue maintaining and operating the marginally profitable narrow gauge lines by requiring:

- the lessee to complete the 'grain line strengthening plan' by 2004 to upgrade the standard of the narrow gauge lines
- the lessee to fund all works required under the lease until December 2006, regardless of the profitability of the line (unless there was a material change in circumstances)
- the lessee to wait until after December 2006 before it could request that a line be dropped from the lease, or its upkeep funded by the State and then only if the line appears likely to create losses for the lessee, and the line is carrying low traffic.

These mechanisms in the lease were designed to meet the government's policy objectives in 2000 of ensuring that the rail network would evolve to meet market needs in a planned way. The policy position on the grain lines has developed over time, resulting in some adaptation of the lease conditions and requirements. (See Appendix 1.)

In 2004 the completion of the GLSP was deferred to 2008, and then in 2010 some requirements of the plan were waived in favour of works on other areas of the network. Government also agreed to fund major re-sleepering works, but without following the process set out in the lease to decide whether 'uneconomic lines' should be surrendered or maintenance funded by the State.

PTA advised that these key policy decisions were made by the responsible Minister and by Cabinet.

The lease required completion of the 'grain line strengthening plan' by 2004, but changing government policy called for the deferral of these works

The lease required that the lessee would complete final phase of the GLSP by 30 June 2004, for five of the 10 lines specified in the lease, at an estimated cost of $50 million. Following a request in August 2003, the State entered into a Deed of Variation in May 2004, deferring the completion of the GLSP works until the end of December 2008 (Table 2), and agreeing that the lessee instead undertake concrete re-sleepering of the line between Pinjarra and Kwinana.

PTA informed us that these decisions were driven by the policy priorities of the government of the day, and were taken under considerable time pressure. The GLSP was an interim measure started by the State in the 1990s, designed to prolong the life of failing sleepers on the grain lines until the cyclical replacement of sleepers could be carried out in the mid-2000s. PTA considered that the completion of the GLSP would have been of questionable long-term benefit, because grain freight was shifting from rail to road in these areas by 2004.

While the State may have achieved benefits from the change to the lease requirements on the GLSP, the documentation of the decision-making process was insufficient to demonstrate a full and comprehensive analysis of options and risks. The introduction of a structured contract management plan and supporting risk analysis should assist PTA to take and document a more structured approach to decisions to modify the lease in future.

Line	Type of work	Expected completion date	30 June 2004 completion achieved	Work completed by December 2008	Waived
Tambellup – Gnowangerup	Formation improvements	'as soon as possible'	No	no	Waived 2010
Katanning – Nyabing	Formation improvements	'as soon as possible'	No – Deferred	no	Waived 2010
Bullaring – Bruce Rock	Sleeper replacement	30 June 2004	No – Deferred	no	Waived 2010
Yilliminning – Bullaring	Sleeper replacement	30 June 2004	No – Deferred	no	Waived 2010
Toodyay West – Miling	Sleeper replacement	30 June 2004	No – Deferred	'Yes' (PTA)	n/a
Burakin – Beacon	Selective re-ballast	30 June 2004	'Yes' (PTA)	n/a	n/a
Yilliminning – Kulin	Selective re-ballast	30 June 2004	'Yes' (PTA)	n/a	n/a

Table 2: Grain lines and the timeframe for work to be completed by 30 June 2004, as specified in the original lease

In August 2003 the lessee requested that the GLSP works be deferred for three grain lines (Katanning to Nyabing, Bullaring to Bruce Rock and Yilliminning to Bullaring). These lines were carrying low levels of freight, but under the lease State funding could not be sought or the lines surrendered until December 2006.

The lessee's request was referred to the recently formed PTA from the Department of Planning and Infrastructure in October 2003. PTA approved the deferral of the works 'in principle' on 22 October 2003. PTA used information from an audit of a third party to confirm the cost of the works required to restore the lines to a 'fit for purpose' state, and gave final approval to the deferral of the GLSP in November 2003. PTA did not independently verify the accuracy of the lessee's costs and supporting data until after it had given approval to the deferral of the GLSP works. On 22 March 2004 Cabinet authorised the deferral of the remaining GLSP works from 2004 to 2008.

The lessee was solely responsible for the costs of keeping all lines fit for purpose for the first six years of the lease, until December 2006. By deferring the completion of the GLSP beyond the first six years of the lease, the State risked these costs passing from the lessee to the State on any low-traffic uneconomic line. After December 2006, the State could expect to bear the cost of works on any low-traffic line which could be qualified as 'uneconomic', or accept the surrender or effective closure of the line. PTA and other stakeholders considered a range of risks and trade-offs under the proposal to defer the GLSP, although we did not find any consideration of this specific risk.

In exchange for the 2004 deferral of the GLSP, the lessee completed concrete re-sleepering of the non-grain network line between Pinjarra and Kwinana by December 2005. The Pinjarra-Kwinana line was experiencing rapid freight growth due to the 2004 upgrade of Alcoa's Pinjarra Alumina Refinery. The lessee is obliged under the lease to maintain the Pinjarra-Kwinana line to meet the needs of all rail users, and specifically to meet Alcoa's rail freight requirements under a related State Agreement.

While the works on the Pinjarra-Kwinana line were undoubtedly valuable for the State, based on the documentation available to us it remains unclear whether PTA conducted an assessment of whether the lessee would have undertaken these works based on commercial incentives, in which case the investment required under the GLSP could have been directed elsewhere.

Reflecting the 2009 Strategic Grain Network Review, the requirement to complete the GLSP as originally specified was removed in 2010, funding was directed to works on some Tier 1 and 2 lines, and PTA agreed to the lessee withdrawing some grain lines from service unless government funding was provided

The 2009 Strategic Grain Network Committee Review recommended that the State should support re-sleepering works required on lines regarded as viable (classified as 'Tier 1 and 2'), and withdraw investment from lines regarded as unviable (Tier 3) (see Appendices 1 and 4). Following this recommendation, in July 2010 PTA entered into a project agreement to fund the major re-sleepering works required on certain Tier 1 and 2 grain lines, while allowing Tier 3 (and potentially some Tier 1 and 2) lines to be progressively withdrawn from use by placing them in care and maintenance, rather than surrendering them from the lease. In considering the 2010 project agreement PTA relied on the Strategic Grain Network Committee analysis of which lines were suitable for investment, rather than conducting new analysis of the proposals in the agreement.

The funds remaining under the GLSP for Tier 3 lines were re-allocated to certain Tier 1 and 2 grain lines, and the requirement to complete unfinished parts of the GLSP as specified in the lease was removed. PTA accepted the lessee's valuation of the works that were not required to be completed. The lessee valued these outstanding works at $16.5 million. This was less than our estimate of the cost of these works at $29 million, using the original Westrail plan costings from 2000.

PTA's agreement to fund the major re-sleepering works required on certain Tier 1 and 2 grain lines reflected the government's policy objectives to pre-empt the shift of grain freight from rail to road on those lines. However, it departed from the lease mechanism that limited the State's financial liability to lines that carried less than 200 000 net tonnes per year. PTA did not require the lessee or use an external expert to demonstrate that freight carried on the lines had fallen below the tonnage threshold required by the lease.

PTA advised that if government had not agreed to fund the re-sleepering works, the Tier 1 and 2 lines would have either degraded due to an ongoing dispute with the lessee, or the completion of the works by the lessee at its own expense would have increased rail access prices to levels that would have made the lines no longer competitive with road. In either case, PTA advised that the Tier 1 and 2 lines would eventually have suffered a significant reduction in use and would have qualified for government funding or surrender under the lease. By that time it was likely to have been too late and too costly for the State to intervene and reinstate the grain lines as a competitive freight option. While we found these reasons persuasive, PTA did not conduct economic modelling or market analysis to demonstrate that these projections were well-founded, and relied on the December 2009 recommendations of the Strategic Grain Network Committee.

Rather than risk being left holding and maintaining surrendered grain lines, under the 2010 project agreement PTA placed the lines regarded as 'uneconomic' into care and maintenance by the lessee. The lessee is not obliged to continue operating those lines or maintaining them in an operational condition. To enable this, the project agreement introduced a different definition of 'fit for purpose' for these lines, by removing the requirement that the lines should meet the requirements of rail users and keep pace with technological change.

The two most likely outcomes anticipated in the lease are for low-traffic and uneconomic lines to be either funded by the State, or surrendered from the lease and returned to the State, which would then seek an alternative operator. Placing lines into care and maintenance is covered by another lease clause that allows the State to make 'other arrangements' when dealing with uneconomic lines. PTA also advised that the agreement saved the State the expense of maintaining the lines, estimated at just under $2 million per year, and the risk and expense associated with possibly being required to bring those lines back into service.

The treatment of the grain lines demonstrates the effect that the changing policy and market environment can have on PTA's capacity to implement the lease as originally drafted. The options envisaged under the lease – State funding or surrender of the lines – both have potentially significant costs and uncertainty attached to them. PTA has adapted the lease to seek to manage these risks and minimise costs to the State.

If the State had chosen to fund the capital works required for the Tier 3 grain lines, the costs would have been substantial. If the lines had been surrendered, the State would have had to conduct basic maintenance for which it no longer has the capacity other than through the lessee. PTA estimated saving around $2 million a year in avoiding this through care and maintenance.

PTA would then have had to seek alternative operators, and conclude an agreement with them. There is uncertainty about whether an alternative operator could make the lines viable, whether an agreement could be reached and how long it might take. It is also likely that an agreement would require capital funding from the State. Given these levels of uncertainty, there are benefits for the State in placing the lines into care and maintenance while leaving them with the existing lessee.

However, the treatment of the grain lines also shows why PTA needs to be able to demonstrate that it has fully considered all options and risks, and is continuing to monitor them against changing circumstances. For instance, the short term cost saving of $2 million a year on maintenance has since been offset by PTA having to fund the lessee $3.3 million to re-open particular Tier 3 grain lines, because road upgrades to take the grain freight from these Tier 3 lines had not been completed in time for the 2011 harvest.

Placing the lines into care and maintenance while leaving them with the current lessee potentially obstructs prospective new operators from entering the market. This also benefits the lessee by reducing the likelihood of competition while allowing the lessee to retain the right to future economic benefit from disused rail line corridors. The uncertainty over whether the market can provide an alternative viable operator can only be fully resolved by testing the market, which PTA has not formally done. However, it has received unsolicited approaches.

In these circumstances PTA needs to be able to demonstrate clearly that its decisions protect the State's interests in the long and short term. Again, while we found PTA's explanation of how this position has evolved and the issues they have considered persuasive, a more structured approach within a formalised contract management plan would enable PTA to more readily demonstrate the basis for its decisions.

Risks relating to the end of the lease will require monitoring and proactive management

As the end of the lease approaches, the interests of the lessee and the State are likely to diverge. This is because, without an agreement to renew the lease, the lessee faces a commercial risk that the future benefits from its investments may flow to the State or to a new lessee, and this will affect investment and maintenance decisions by the lessee. This represents a risk to the condition of the network. End of lease issues are already influencing the commercial relationship, and will require monitoring and proactive management by PTA.

While these issues will become most critical and start to manifest about 15 years from the end of the lease, they will influence the commercial relationship between the lessee and the PTA earlier than that. This was evident in 2011 when the lessee approached the PTA to begin ongoing discussions regarding an extension to the lease. PTA needs to consider its approach to these risks and have processes in place, as part of a contract management plan, to effectively monitor lessee activity in the later years of the lease.

In simple terms, a commercially prudent lessee will begin reducing new investment in the network as soon as the useful life of a proposed investment exceeds the remaining term of the lease, or as soon as the lessee faces a reduced return on investment due to the approaching end of the lease.

Many assets in the rail freight network have long life spans, and ranging from approximately 20 years for a quality timber sleeper, to more than 100 years for a bridge or re-aligned rail formation. While this does not drive the timeframes in which the lessee can derive a return on its investment, it will be a consideration in investment decisions particularly on more marginal lines.

The lease provides some protection for the State in requiring the lessee in year 45 of the lease to place in an escrow (a trust) account funds equivalent to five years of maintenance, to cover the State for the costs of maintenance and repair works required if the network is returned not in a 'fit for purpose' condition. There are two risks associated with this that the PTA must manage:

- 'fit for purpose' currently relates to the performance standards in the lease, which are set at year 2000 levels and have been revised in two instances – to reduce standards on some grain lines to place these lines into care and maintenance, and to increase standards on the Eastern Goldfields Railway following government funded improvements. If this is still the case at the end of the lease, then the lessee's obligation would be to return the network at those standards and the escrow account would provide little protection. To manage this risk PTA needs to ensure that the performance standards are regularly updated to reflect the contemporary needs of rail users
- there is a potential incentive for the lessee to minimise the actual amount it has to place in *escrow* and to do this it may reduce spending in the years prior to year 45 to establish a lower baseline of maintenance spending. To manage this risk, PTA should ensure it is effectively monitoring maintenance and repair activity to detect any changes in patterns of activity.

Appendix 1: Grain lines policy development

1960s–1990s	A significant number of grain lines were closed by government on the basis that these lines were not economic to operate (see Appendix 5).
1996	Government takes interim measures to prolong the life of existing sleepers on the grain lines by inserting steel sleepers to replace every fourth timber sleeper. The $340 million grain line strengthening plan (GLSP) was intended to delay until the mid-2000s the need for a major project to completely replace the existing sleepers, which were approaching the end of their useful life.
2000-2004	At the signing of the lease in 2000, the lessee agreed to complete the final $50 million phase of the GLSP at its own expense by 30 June 2004, unless there was a material change in circumstances. Changing government policy saw the completion of the plan deferred in 2004 until 2008, and unfinished parts of the GLSP were waived in 2010.
2007	PTA advise that in 2007 the lessee approached the State government, seeking to surrender certain low-traffic uneconomic grain lines from the lease, or to obtain State funding to cover losses expected in the continued operation of these lines. The lessee submitted that these lines were uneconomic, due to the cost of the impending project to replace sleepers at the end of their life cycle.
2008	The State Government's Grain Infrastructure Group (GIG) report published in March 2008 acknowledged that grain lines in some regions would be financially uncompetitive with road freight if the lessee's costs of completing the major re-sleepering works were passed on to rail users in higher access charges. The GIG report also noted that the cost of the initial road upgrades to carry the grain freight task would be equivalent to the cost of the rail re-sleepering project, and that ongoing road maintenance to the required standard would not be cost-effective. The report recommended that government invest around $400 million in re-sleepering works required on all of the grain lines. The GIG report identified economic, social, safety, and environmental benefits in keeping grain freight on rail.
2008	The State election in 2008 was called prior to the GIG recommendation being considered by Cabinet. The election led to a change in government, and a reconsideration of policy regarding the grain lines.
2009	In the absence of a government decision on whether to fund the cyclical replacement of all sleepers on the grain lines, the lessee began withdrawing some lines from service in 2009.
2009	PTA commissioned an expert review of the lessee's claims that most of the grain lines were uneconomic in 2009. The review agreed that some sections of the grain network had degraded to the point where they were now unfit for purpose, and that most of the narrow gauge grain network would rapidly become unfit for purpose unless the cyclical re-sleepering works were carried out.
2009	The 2008 GIG study was reviewed by KPMG in 2009, at the request of the Commonwealth government. KPMG found that the grain lines would be uneconomic for the lessee if the required re-sleepering works were carried out, but did not comment on whether the grain lines would be uncompetitive with road freight if the lessee's costs of completing the major re-sleepering works were passed on to rail users in higher access charges. KPMG took the view that the GIG report had over-estimated the cost to the State of road accidents and other externalities caused by closing grain network rail lines.
2009	In response, the State Transport Minister established an advisory committee (the Strategic Grain Network Committee) in 2009 to comprehensively review the grain network and advise as to which lines should remain open. The Committee recommended that the grain rail network should be used to its maximum potential, particularly since much of the regional road network was not fit to handle the seasonal grain freight task.

2009	The Committee described the grain network as having three 'tiers' of lines, and found that 34 per cent of the grain network was not competitive with road. The Committee recommended that the State pay for work on what it regarded as the most extensively used parts of the grain network (Tiers 1 and 2), and allow other lines (Tier 3) to fall out of service. The Committee also recommended that the State fund road works to allow the grain harvest in Tier 3 districts to be carried by truck. The Strategic Grain Network Review report received unanimous support from all committee members at its last meeting, but a number of members later reconsidered their support.
2010	Early in 2010, PTA endorsed the Strategic Grain Network Committee's recommendation that Tier 3 grain lines should be taken out of service (see Appendix 4 for grain line closures as originally proposed). Government funding was also approved to install more steel sleepers to improve efficiency and to replace a large proportion of expired or expiring timber sleepers on 'Tier 1 and 2' lines.
2010	PTA advise that in June 2010, the lessee decline to enter into an access agreement with a grain freight carrier, on the basis that the grain lines were not economic to operate. The responsible Minister directed PTA to negotiate a resolution on the grain lines, including the unfinished works under the GLSP.
2010	PTA entered into a 're-sleepering' project agreement with the lessee in July 2010, which waived the completion of the GLSP, while allowing the lessee to spend $16.5 million earmarked for these works on other parts of the network. This agreement states that without government funding for re-sleepering works, 67 per cent of the grain network (1 450 kilometres of track including nine Tier 1 and 2 lines) would be placed in non-operational care and maintenance by 2013–14. These lines would remain in the possession of the lessee without requiring the lessee to maintain or operate these lines. Office of the Auditor General analysis indicates that $29 million of works on the GLSP were outstanding at the time that these works were waived, but the lessee costed the remaining works at $16.5 million. In line with the recommendations of the Strategic Grain Network Committee review, the State has approved funding for works on Tier 1 and 2 lines, but has not approved funding for Tier 3 lines. Funding to re-sleeper some grain lines was approved before the agreement was signed.

Appendix 2: Key reports related to the network

Track condition reports (Audits of compliance with performance standards)

- *Review of WestNet Rail compliance with the initial performance standards* by Worley Parsons, July 2005. This is the '2005 Track Condition Report' commissioned by the lessee and accepted by PTA.
- *Physical review of proposed re-sleepering*, August 2009. This is the 2009 review of the lessee's claim of 'uneconomic' lines requiring re-sleepering works. Commissioned by PTA, and used by PTA to supplement the 2010 Track Condition Report. PTA used this report in place of a track condition report regarding the grain lines in 2010.
- *Audit of compliance with the initial performance standards*, August 2010. This is the '2010 Track Condition Report' commissioned by the lessee and accepted by PTA. This report did not consider or report on the condition of the grain lines. PTA relied instead on the 2009 review of proposed re-sleepering of the grain lines (below).

Report concerning the lessee's 2009 claim of 'uneconomic' grain lines

- *Physical review of proposed re-sleepering*, August 2009. This is the review of the lessee's claim of 'uneconomic' grain lines requiring re-sleepering works, commissioned and paid for by PTA. PTA used this report in place of a track condition report regarding the grain lines in 2010 as noted above.

Reports concerning grain lines

- 2003 *Audit of grain line condition for WestNet Rail*, performed by Queensland Rail.
- 2004 *Verification of an audit of grain line condition performed by Queensland Rail for WestNet Rail*, by Bovis Lend Lease, April 2004.
- *Western Australia's Grain Freight Network Review* by the Grain Infrastructure Group (GIG), March 2008.
- *Report into the claim by WestNet Rail that certain grain lines are uneconomic* by KPMG, August 2009. This is the review of the commercial viability of the grain freight network, commissioned by the Commonwealth Government.
- 2009 *Strategic Grain Network Committee (for Freight and Logistics Council of WA) Report*, December 2009. This is the report that classified the grain network into three tiers, and recommended funding for Tiers 1 and 2, with Tier 3 to be withdrawn from use.

Sale and lease Taskforce documents

- 1998 *Sale of Westrail Scoping Study* by Mercer Management Consulting, Blake Dawson Waldron, Booz Allen & Hamilton, Deutsche Morgan Grenfell, Skea Nelson & Hager, July 1998.
- 1999 *Report of the Standing Committee on Public Administration in relation to Inquiry into Government Proposals for the sale of lease of Westrail Freight Operations*, September 1999.
- 2000 *Information Memorandum for Westrail Freight* (Rail Freight Sale Task Force), June 2000.
- 2001 *Report on the Sale of Westrail's freight business* by Rail Freight Sale Task Force, July 2001.

Appendix 3: The State rail freight network

Source: Brookfield Rail

The rail freight network spans the southern part of the State from Geraldton in the north to Kalgoorlie in the east.

The standard gauge network has two lines, Kalgoorlie to Northam (Avon), and Leonora to Esperance. It covers 1 350 kilometres and carries 80 per cent of all general freight coming from the East Coast, along with 132 000 passengers annually. The standard gauge line from Kalgoorlie to Northam is made up of continuous welded rail laid on steel or concrete sleepers, bedded on granite ballast. The Leonora to Esperance line still has a large proportion of timber sleepers.

The narrow gauge network accounts for most of the rest of the rail freight network and covers 3 950 kilometres, although around 415 kilometres of this network were classified by PTA as 'non-operational' at the time of the lease. The network extends from Mullewa to Albany, with much of it made up of light-weight rail laid on timber sleepers, some in conjunction with steel sleepers and gravel or blue-metal ballast. The rail track on some light-weight lines dates back to the early 1900s.

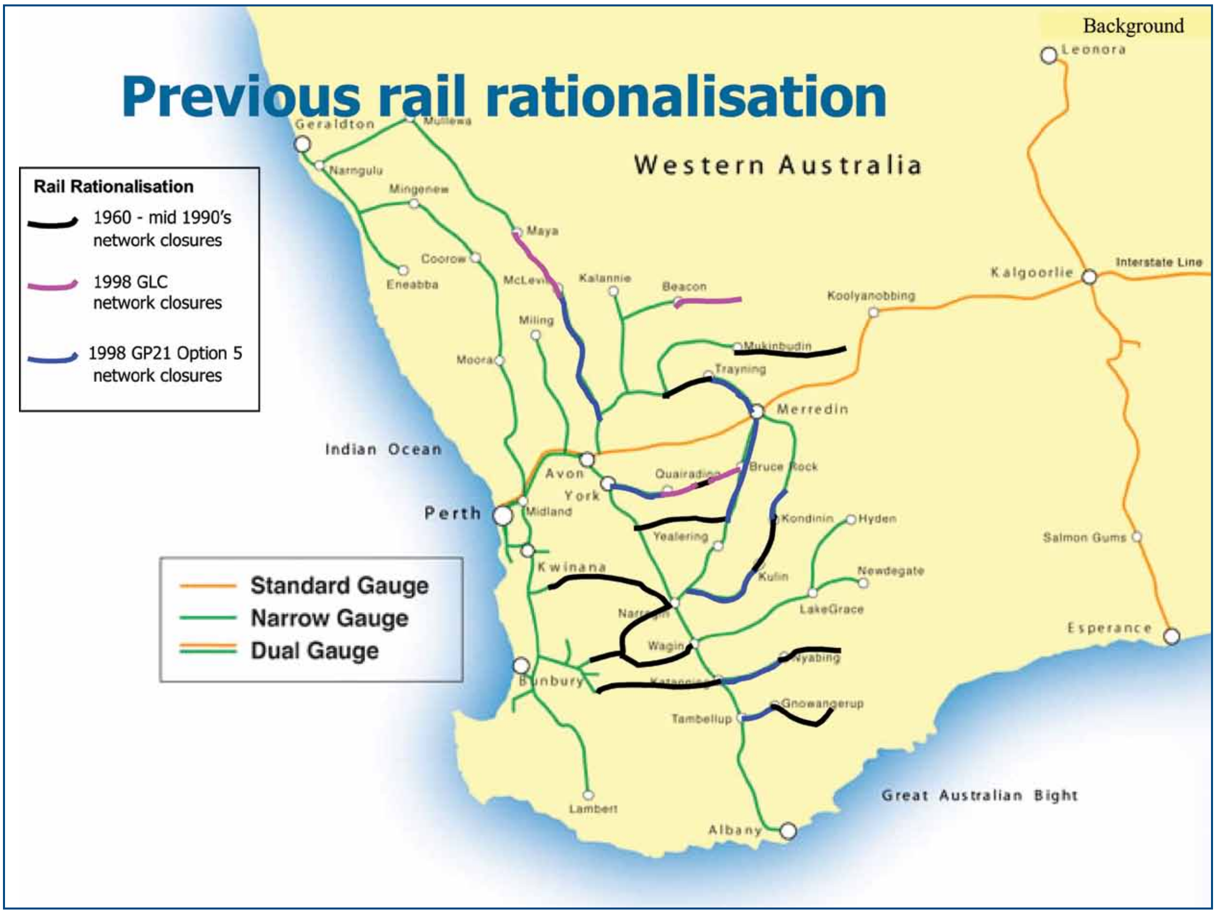
The dual gauge network covers 300 kilometres and operates from Northam (Avon) to Kwinana, accommodating both standard and narrow gauge trains. A large section, from Cockburn to Forrestfield, still has timber sleepers. The dual gauge lines are some of the busiest parts of the network, carrying more than 11 million net tonnes of freight a year.

Appendix 4: Grain lines at 1 July 2011

Source: Brookfield Rail

Grain lines at 1 July 2011 (funding was subsequently made available to re-open the Tier 3 lines closed on 30 June 2011 for the 2011–12 harvest).

Appendix 5: Previous rationalisation of the grain network



Source: Grain Infrastructure Group 2008

Rationalisation of the grain freight rail network since the 1960s.

Auditor General's Reports

REPORT NUMBER	2012 REPORTS	DATE TABLED
15	Managing the Road Trauma Trust Account	14 November 2012
14	Audit Results Report – Annual 2011-12 Assurance Audits	7 November 2012
13	Implementation of the National Partnership Agreement on Homelessness in Western Australia	24 October 2012
12	Major Capital Projects	17 October 2012
11	Second Public Sector Performance Report 2012 – Business Continuity Management by Port Authorities – Western Australian Natural Disaster Relief and Recovery Funding – Housing's Implementation of the Head Contractor Maintenance Model	26 September 2012
10	Information Systems Audit Report	28 June 2012
9	Public Sector Performance Report 2012 – Regional Procurement – Department of Commerce Support to the Plumbers Licensing Board – Ministerial decision not to provide information to Parliament on the amount of funding tourism WA provided for the Perth International Arts Festival	28 June 2012
8	New Recruits in the Western Australia Police	20 June 2012
7	Pharmaceuticals: Purchase and Management of Pharmaceuticals in Public Hospitals	13 June 2012
6	Victim Support Service: Providing assistance to victims of crime	16 May 2012
5	Audit Results Report – Annual Assurance Audits completed since 31 October 2011 including universities and state training providers and Across Government Benchmarking Audits: Accuracy of Leave Records; Act of Grace and Like Payments; and Supplier Master Files	16 May 2012
4	Supporting Aboriginal Students in Training	2 May 2012
3	Beyond Compliance: Reporting and managing KPIs in the public sector	19 April 2012
2	Opinion on Ministerial decisions not to provide information to Parliament on the amount of funding Tourism WA provided for some events	22 February 2012
1	Working Together: Management of Partnerships with Volunteers	22 February 2012

The above reports can be accessed on the Office of the Auditor General's website at www.audit.wa.gov.au.

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