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Dr Stephen King
Commissioner
Australian Competition & Consumer Commission
470 Northbourne Avenue
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Copies: Mr Scott Gregson, ACCC
Mr David Hatfield, ACCC

Dear Dr King

AWB/GrainCorp JV: Pre-decision conference
Summary of Points Made by Pacific National

It was a pleasure to meet you on Monday.

I found the conference most interesting and, from our perspective, the issues raised by a number of the participants and the responses of the Applicants highlighted a number of matters which clearly need further assessment.

In response to your invitation to make any further written submissions by 21 February 2005, I thought it would be useful to summarise some of the points I made on Monday, as follows:

1. **What might be the proponents' objective?**

   (a) achieving full vertical integration of the export grain chain to the extent of the GrainCorp train "baseload" tonnage;

   (b) favouring AWB/GrainCorp storage and handling facilities by differential freight deductions to attract additional grain to those facilities (even potentially extending to the provision of rail services at less than full cost);

   (c) a shift of grain over time into AWB/GrainCorp storage and handling facilities;

   (d) other storage and handling facilities, Pacific National and other train operators will compete for the balance of the highly variable task at higher cost (price):

   (Using the Victorian grain harvest as an example, because of the variability of the grain task, a train operator who is guaranteed the first 1 million tonnes of the task has 100% certainty that it will carry that amount; the train operator allocated the task of carrying 3rd to

4th million tonnes of grain of the season can only expect to carry its allocated amounts in 25% of years and therefore its equipment will only be used 25% of the time - that operator will therefore have to charge much higher rates per tonne in order to cover the fixed costs of keeping this equipment available in the majority of years when the volume is not produced);

(e) opportunity for GrainCorp (or AWB) to expand grain haulage function and vertical integration of export grain chain over time as strategy succeeds; and

(f) raising of barriers to entry for competitors for the post-deregulated export grain sales in grain marketing, in storage and handling and in haulage.

2. **What does this mean for the export grain sector?**

(a) longer term competition for storage and handling facilities reduced;

(b) viable entry post de-regulation of export grain marketing made more difficult;

(c) competition and entry of viable further competitors for grain haulage in the future reduced because stable "baseload" task has been cherry-picked;

(d) lack of certainty will preclude investment by third party operators such as Pacific National; and

(e) without certainty and a sustainable base, operators such as Pacific National may withdraw.

3. **What are the public benefits?**

(a) a number of issues raise doubts about the claimed benefits, including:

(i) the joint venture will only improve short term planning, and will not deal with other inefficiencies;

(ii) Pacific National's current New South Wales contract with AWB does not expire until 2006; and

(iii) there will be material changes in grain haulage in NSW in 2007;

(b) the joint venture will not be able to replicate the success of the Hunter Valley Coal Chain industry group.

Pacific National has consistently said that it believes that there are potential efficiency savings of the order of $15m per year to rail costs which can be made through the implementation of a range of changes (including suitable targeted investment) across the supply chain. In referring to the "supply chain", we mean the entire connected process including ordering, up-country storage and handling, rail linehaul and port operations.

As we have understood more about the structure of EGL and how it may operate since the interim authorisation, we now consider it less likely that EGL will be able to achieve these savings in a number of areas and we conveyed this updated position to the ACCC in our submission of 7 February 2005. In that document we downgraded our expectation of cost savings to between 2.5% and 5%, equivalent to a range of $5m to $10m per annum.

The pre-decision conference of 14 February 2005 has caused Pacific National to question these savings further and to consider that there are alternate means of obtaining many of these benefits other than the formation of a Joint Venture company.

4. **What is the solution?**

(a) non-discrimination and objectivity in selection of rail operator to preserve competition in handling and haulage - this requires:

(i) fair and clear tendering processes which:

A. define the task (eg. tonnages, market share, priority in task allocation process, geography) and how task will be managed/allocated over the period;

B. do not unfairly discriminate in favour of the AWB/GrainCorp;

C. ensure all tenderers have equal access to relevant information;

D. are at arm's length from JV shareholders; and

E. comprise terms which are competitively neutral as between third parties and GrainCorp/AWB;

(ii) audit of tendering, task allocation process and freight allocation process by a third party probity auditor on an annual basis; and

(iii) transparency of allocation of rail freight charges across the silo network to ensure no geographic bias at the expense of other storage facilities;

(b) prevention of third party confidential information sharing by the joint venture with its shareholders through ring-fencing arrangements;

(c) a time limit of November 2007 on the authorisation because at that time there will be a material change in the circumstances of grain haulage in NSW and no safe conclusions can be drawn now about comparative detriment and benefit beyond that date.

This solution has the advantage of not requiring ongoing monitoring by the ACCC as non-compliance will be apparent to industry participants (especially if a requirement is imposed to have an independent auditor report on compliance on an annual basis). Further, the Commission is well used to these type of conditions to provide safeguards in vertically integrated sectors (for example, as you are aware, rail access regulation contains these rules already in Queensland, Victoria, WA and SA/NT mentioned in Pacific National's submission of 7 February 2005).

In light of comments made by a number of participants at the conference, and the Applicants' responses, I thought it would be useful to provide, in an Appendix to this letter, some questions the ACCC may wish to ask the Applicants because the information so far supplied does not seem to adequately address these issues. The issues and questions go to the following:

(d) the quantum of potential benefits attributable to the joint venture;

(e) the way in which these benefits are to be achieved;

(f) the treatment of likely rating structures under future transparency arrangements for freight rates;

(g) the process of ensuring a level playing field for all operators and confidentiality controls; and

(h) whether savings that are claimed by the JV should strictly be attributed to the particular structure of this JV, and could not be achieved in normal commercial contracts between AWBL and Graincorp and rail haulage operators and AWBL.

Please let me know if you would like any further information about the matter.

Yours sincerely

Stephen O'Donnell
Chief Executive Officer

Appendix - Questions for the Applicants

1. Quantum of Potential Benefits Really Attributable to the Joint Venture

Why do AWB Ltd and GrainCorp need EGL in order to be able to achieve the benefits claimed?

Specifically, what are the added quantifiable benefits that the Joint Venture company brings, what could be achieved through negotiations and why is the Joint Venture company able to make the difference in such circumstances?

2. **How are the Potential Benefits to be Achieved?**

One of the keys to having a more efficient rail operation is to make it run more consistently, similar to a production line. Currently, there are too many interruptions of varying frequency and length. To be able to better assess possible gains, the ACCC needs to consider:

What specifically is EGL committing to do to achieve more consistent rail traffic flows?

The existence of sufficient port storage is necessary to achieve the above consistency.

Given that EGL does not control storage facilities, how does it intend to overcome impediments that these facilities have on the ability to improve rail operational efficiency?

The grain handling aspect of storage and handling also affects rail efficiency. For example:

How does EGL intend to overcome issues such as grain infestation which can bring equipment to a standstill?

Underloading of grain wagons at upcountry storage facilities has been an on-going problem for rail operators with consequent inefficiencies in equipment utilisation. While we note that the claim by the Applicants at the Conference that they think that wagon loading has improved in the interim approval phase of EGL, we are not sure that there has been a noticeable improvement. Further, if there has indeed been change, we would expect that it is more likely to have been brought about by the discussions which Pacific National has been having with AWB and GrainCorp on this matter in recent months.

What specific steps will EGL undertake to improve the performance of loading at up-country storage facilities?

Comparisons to the coal rail operations in the Hunter Valley have been cited as an example of why EGL will work. An intrinsic reason for the success of the Hunter Valley model is that the logistics group consists of coal producers, port owners, above and below rail operators working together to achieve the desired efficiencies in supply chain operations. The EGL Joint Venture is fundamentally different in its composition in that it is made up of non-rail staff who have no line control over rail operations.

What specifically does EGL intend to implement which will achieve benefits which can be compared to the Hunter Valley coal experience?

In order to achieve the supply chain benefits claimed, there should be a more equitable allocation of risk between the rail operator and EGL. Risk should be allocated to the party that can best manage it.

3. **The Treatment of likely Rating Structures under Future Transparency Arrangements for Freight Rates**

There is a high probability that rail freight rates for grain will increasingly be composed of fixed and variable components as compared to the fully variable rate structure which was previously the norm. (The fixed component is to cover the industry requirement of ensuring that capacity is maintained for the good years while knowing that there will be intervening bad years). The Applicants espouse the goal of freight rate transparency but have not advised how this will apply in practice with a varied rating basis.

If a major part of freight costs will be incurred on a fixed plus variable basis, what are the specifics of how EGL intend to transform these charges into freight rates to be charged at each silo?

4. **The Process of Ensuring Level Playing Fields for all Rail Operators**

Pacific National, and, we expect, all other rail operators besides GrainCorp, have no information about the basis on which EGL intends to procure rail freight services. The only observation we can make to date is that they intend to favour rail services provided by the Applicants themselves. For an effective and efficient rail service to exist for grain exports, the rail industry needs to know that fair competition will be possible.

What are the specific processes which EGL will follow in the market place to ensure competitive neutrality in the procurement of rail services?

What methodology will be used to allocate freight rates to individual storage and handling facilities if different freight purchasing strategies are followed; and

If, for example, a rail operator wished to build its own storage and handling facility, could it negotiate directly with AWBL for a combined rail and storage handling contract?

Can other storage and handling competitors put a combined storage and handling plus rail charge to AWBL?

In this situation would a rail operator and another storage and handling company be allowed to present grain by the train load to the port?

5. **Confidentiality Controls**

What confidentiality arrangements are the Applicants prepared to commit to which will satisfy the concerns not only of rail operators, but also of their competitors in the grain trading and bulk storage sectors?