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MINISTER FOR PLANNING AND INFRASTRUCTURE

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18 JUN 2008

Mr Graeme Samuel
Chairman
Australian Competition and Consumer Commission
GPO Box 3131
CANBERRA ACT 2601

URGENT

Dear Mr Samuel

Supply Chain Transport Coordination for Bulk Grain Movements in Western Australia

Over the past three years, the grain industry has been evaluating the grain freight network in Western Australia to determine how it can be made sustainable into the future. This has been done in the context of a Grain Infrastructure Group (GIG) comprising the Department for Planning and Infrastructure (DPI), Chair, Co-operative Bulk Handling Limited (CBH), Australian Wheat Board (AWB), Australian Railway Group (ARG) and Westnet Rail.

I have met with CBH to discuss a number of issues of mutual interest. One of these was the termination of the longstanding Freight Grain Agreement between CBH, AWB and the rail companies for the haulage of grain from inland country storage to Western Australia's four major ports (Kwinana, Geraldton, Albany and Esperance).

It is of concern to the State Government that, in the face of emerging trends associated with the deregulation of grain marketing, there could be a significant leakage of tonnes from the rail network to the road network, sufficient to threaten the viability of the supply chain network which is currently the most efficient such network in the nation. These factors are:

- The escalation in the number of grain marketers;
- The significant fixed cost investment in the grain supply chain networks for land transport (rail and road), storage, loading and handling at the ports;
- Markedly different investment and cost recovery regimes for the land transport modes with consequent differentials in government subsidisation between road and rail;
- The unfavourable ratio between the size of the transport task and the unit of production in Western Australia; and

- The already wide gap in market prices between rail and road, and the significantly large gap between marginal cost and market price for road, constituting a competitive market failure which results in a modal share distortion from rail to road, with economic consequences at taxpayer expense.

CBH has proposed the establishment of a supply chain coordination function for grain transport in Western Australia and a logistical management system that promotes competition in the marketing of grain while, at the same time, imposing a logistics protocol to maintain an efficient supply chain. Independent consultants have assessed the CBH proposal in a study jointly commissioned by the Department for Planning and Infrastructure and the Department of Agriculture and Food WA. A copy of that report is attached for your consideration.

The Western Australian Government supports the "Grain Express" proposal as it promotes the efficient and complimentary use of the land transport modes without hindering intra-modal competition.

I appreciate that, as the predominant owner of the storage and handling facilities for grain in this state, CBH could have a leadership role to play. My support for CBH is predicated on a number of conditions being met. These are:

- There will be no discrimination (in price or service) between customers of CBH with respect to grain handling and transport;
- The supply chain coordination function will be implemented within the GIG (or other approved) process with the participation of the government, grain marketers and grain growers;
- In the event of dissatisfaction expressed by a client and not satisfactorily accommodated by those involved in the supply chain coordination, recourse will be made to the economic regulator; and
- New entrants are to be free to avail themselves of CBH services or not, but will be required to contribute towards the fixed costs of the land transport, storage and handling network, i.e. they should contribute to infrastructure provision.

Over the past year, I have approached the Federal Government on a number of occasions for support for the funding of infrastructure for the land transport of grain. CBH has been informed of this. In essence, I have conveyed the following:

"...Detailed work undertaken by the WA GIG has identified the full extent of the investment in land transport infrastructure (rail, road and loading) required to economically sustain the grain industry in Western Australia over the next ten years.

The review has identified a \$400 million 'Rail Rescue Package' for required infrastructure investment in rail resleepering, receival sites (loading, rail and road access) and rail related feeder roads over a ten year period. These projects will be fully justified (with justification criteria compatible with those for the AusLink program).

GIG is proposing that this investment program be funded in equal proportion by the State Government, Federal Government and industry (i.e. \$133m each).

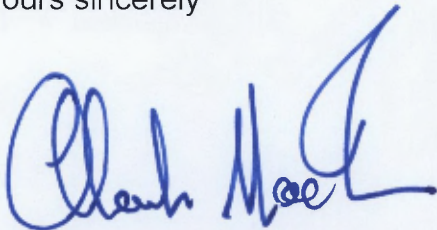
Furthermore, in order to retain grain freight on rail and address current road rail pricing distortions, there is a strong case that the Federal Government should be contributing a market price correction subsidy to compensate rail for the under recovery of road maintenance costs from road train combinations that compete aggressively with rail.

Given the current state of the grain industry post Cole enquiry and the drought last year, a funding contribution of \$133 million on the Federal Government's part appears to be a small price to pay to achieve sustainability of the WA grain freight network for over the next decade or more."

In order to attract future investment in critical infrastructure there needs to be some certainty that the infrastructure will be used, and that tonnes do not flow from the rail network to the road network because it is being more heavily subsidised. This would lead to the demise of the rail network and an increase in total land transport resource costs.

I wish to convey my support for the proposal "Grain Express" to establish supply chain transport coordination for bulk grain movements in Western Australia, and I seek your concurrence with that proposal.

Yours sincerely



ALANNAH MacTIERNAN MLA
MINISTER FOR PLANNING AND INFRASTRUCTURE



WA Department of Planning and Infrastructure
Department of Agriculture and Food WA

**Review of Grain Supply Chain Co-ordination Models
Final Report (Executive Summary)**

May 2008



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GRAINS STUDY FINAL REPORT 16 MAY 2008 (EXEC SUMMARY ONLY).DOC

1. EXECUTIVE SUMMARY

Introduction

Previous analysis by the Grain Infrastructure Group has identified that continuation of rail freight services for export grain in WA will require a substantial injection of capital (estimated \$200m), mostly for track upgrades (resleepering) with complementary investments in roads (\$50 million), fast rail roading and road and rail site access (\$150 million). Before confirming any systematic assistance, however, governments are likely to ask the grain industry to confirm that rail-oriented supply chain co-ordination systems are in place to maximise the utility of rail services on offer.

This paper seeks to identify the co-ordination model that will offer the greatest level of confidence to governments regarding long term rail service viability and transport resource efficiency in Western Australia, without detracting from the benefits offered by the free market conditions now prevalent throughout grain supply chains.

Situation Analysis

The Australian grain logistics industry has undergone a period of almost continuous change and restructuring since the mid 1990s. This period has included privatisations of grain marketing, storage and transport authorities and deregulation of all markets in which they operate.

WA's export grain task in the 1990s was handled by way of a multi-lateral agreement between the key players in the logistics industry, chiefly: CBH, WestRail, AWB, Grain Pool WA and the WAFF. These agreements were a rare example of a commitment by several commercially-oriented parties to work together in a complex task for a common industry/community good. All parties had clear objectives and the boundaries between the interests of each party were also clear.

Within 2 years of the 1997 industry agreement, however, WestRail was privatised, a rail access regime introduced, and AWB privatised. CBH also merged with the Grain Pool, completing the set of fundamental changes to the traditional relationships in the chain and the Agreement. As private companies with narrowly defined shareholder interests, ARG and AWB began to be more focused on financial performance and their position vis-à-vis competitors. AWB also had a mandate to drive reform into the supply chain and introduced competitive pressure for the first time onto both ARG and CBH. CBH, meanwhile, in acquiring GPWA, began seeking synergistic benefits from the supply chain.

The co-operative approach was replaced by a highly competitive environment which proved detrimental to the stability of the relationships.

The impending loss of single desk wheat marketing signals a major change for the grain industry that has the potential to influence all aspects of export grain logistics.

The deregulation of non-wheat grain exports has already led to fragmentation of the export task and some complications for CBH and transporters. The introduction of multiple traders to the market place does not increase the volume of grain produced or exported. It increases the number of customer relationships and adds to the complexity of cargo assembly, particularly where multiple traders buy small grain lots in many locations.

From the rail operator's perspective, the fragmented trade could lead to increased volumes moving to port by road.

The attempts by an exporter to accumulate a cargo from stocks it owns in small quantities in several locations may result in small consignments being trucked, since accumulation of train loads cannot be achieved. Under single desk arrangements, train loads could more readily be arranged from single sites or pairs of sites, since so much grain was under the control of a single owner.

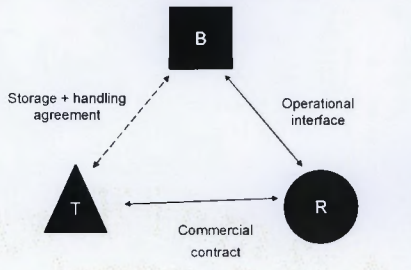
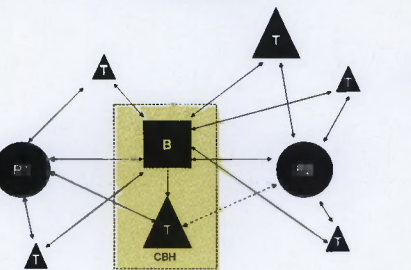
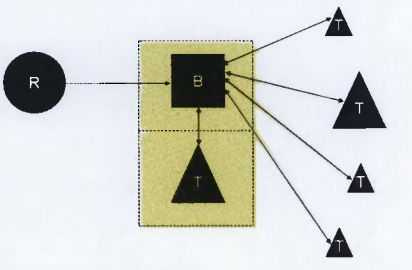
New marketing arrangements for wheat will take effect from July 2008 if the legislation is passed. Under these arrangements, bulk handlers owning export terminals will be required to provide open access to those terminals.

The introduction of these arrangements has been widely anticipated and the trade is preparing for the operation of a virtually free market. In the absence of AWB's stabilising activities, there is expected to be pressure on cargo assembly processes, particularly as traders compete to execute sales contracts in favourable price windows.

The impacts of the new trading environment on both rail operators and bulk handlers will be substantial and will lead to the need for new protocols and commercial relationships. Under single desk marketing, the export market was defined as 'orderly', in that AWB and similar non-wheat grain marketers provided industry-wide stability. The new environment will be more 'disorderly'. In the absence of orderly trade, there will clearly be a need for a more orderly logistics chain, to serve two purposes:

- to allow the bulk handlers to physically move and export grain in the most efficient way
- to provide the rail operator with commercially and operationally optimal conditions

Figure 1 - Alternative supply chain co-ordination models

Model A <u>Traditional single desk model</u>	Model B <u>Multiple rail operator model</u>	Model C <u>Ideal conceptual model</u>
 <p>A single exporter/trader [T], a single rail operator [R] and a single bulk handler [B], each with strongly defined roles.</p> <p>This traditional type of agreement broke down completely as the parties progressively became more commercially oriented from the late 1990s.</p>	 <p>Multi-operator, multi-exporter rail chain. Two (or more) rail operators compete for the same business. The rail operators also face the additional demand volatility arising from the fragmentation of their base load business, particularly in the poorer seasons.</p> <p>The bulk handler now has an added layer of complexity, trying to accumulate cargoes in line with overall rail and road transport efficiency, as well as in line with the volume or service commitments each rail company has with its trader customers.</p>	 <p>A formal separation of the trading and operations arms of the bulk handler is necessary for the company to provide a central co-ordination role for a deregulated trade using the services of a single rail operator.</p> <p>A clean relationship between the rail operator and the operations arm of the bulk handler is achieved. The rail operator has no contract with the trading arm, or with any other trader. Its freight contract with the bulk handler provides incentives and risk sharing devices to stimulate efficient train utilisation. The bulk handler has the express obligation to manage the cargo assembly process on behalf of all exporters and to harness the rail resources in accord with industry agreed protocols.</p>

Grain Express

CBH has recently launched a chain management proposal called Grain Express. The main intent of Grain Express is to simplify cargo assembly and reduce cost by offering a limited number of sites at which traders can execute delivery – essentially the port terminals for export grain, and about 15 key country sites for domestic traders. This system would give CBH considerably more control over site logistics and transport co-ordination than ever before.

This approach will require some management changes by the company and there remains some distrust of CBH's motives within the private trade, perhaps a legacy of its scale, assets and its deep commitment to its grower members rather than to the grain trade per se. The new trading environment will require all bulk handlers to reassess their roles and behaviours. CBH will need to undertake a thorough examination of all services, contract conditions and charges currently applied in line with the expectation that marketers sign over some logistics freedoms and rights to the company.

The intent of the Commonwealth Government in implementing new wheat marketing arrangements from July 2008 has an important regulatory component. The new regime will require bulk handlers to offer open access to all exporters using their port terminals. While bulk handlers currently do offer notionally open access to marketers, the ACCC will become involved in determining what 'open access' means in practical terms, with a greatly fragmented wheat export task. This review is likely to raise a great many questions as to the operation of integrated supply chains and the ownership of trading arms by bulk handlers.

It is in the interests of CBH to work towards an offering to the trade that will head off any futures concerns of the ACCC in this regard. CBH needs to ensure that Grain Express is demonstrably fair and equitable and that it does not run counter to the efforts by the trade to market Australian grain products efficiently and profitably.

Consultation

Initial responses of the private trade to the proposal were wary and largely negative. Since CBH has developed the concept, however, it has worked through the detail with its customers, and they are more accepting of the logic behind it. CBH will need to continue resolving issues of detail in order to gain the level of acceptance it seeks as it approached ACCC in relation to the contentious aspects of the proposal.

Rail contractual issues

The key to the success of Grain Express from the perspective of the rail supply chain is the ability to provide two important conditions:

- a single customer relationship for the export haulage task
- a long term partnership relationship to provide a safe investment climate

For the rail operator, the export grain task is essentially a homogenous transport task, serviced on a common network, using a common fleet. All of the major grain types are hauled in identical fashion irrespective of ownership or quality characteristics. For the rail operator, the operational interfaces with the bulk handler which owns and staffs the loading and unloading facilities for the trains are the key relationships. Under Grain Express, commercial freight terms will also be covered by this simple relationship.

To achieve this, some limitation on the ability of traders to compete with each other in all facets of the supply chain will be needed.

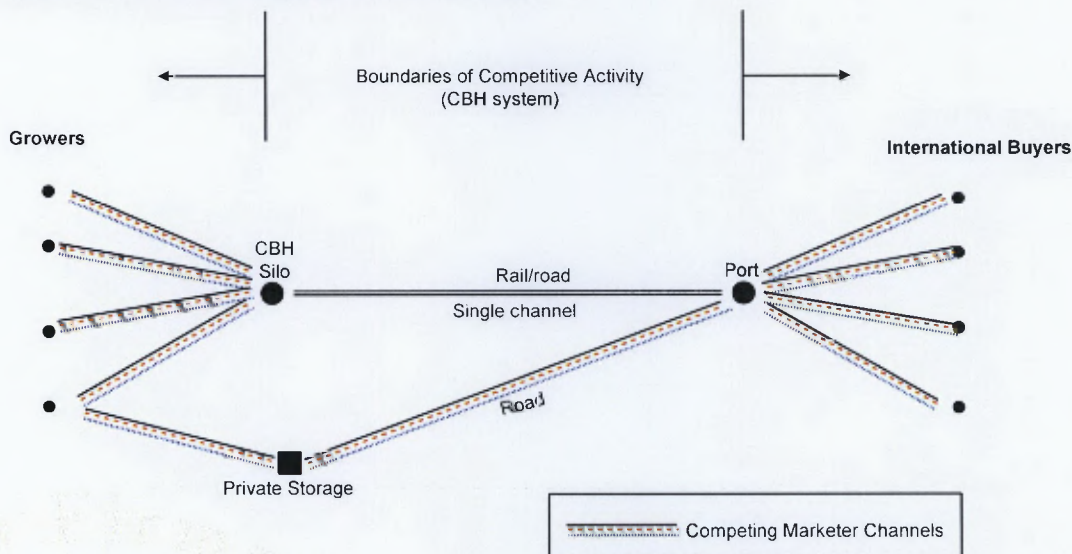
The freedom to compete for international sales does not necessarily bring with it the right to compete at all points in the supply chain, particularly where market failure is a factor. This issue will need to be discussed with federal and state regulators. It might be addressed through authorisation, based on a public interest argument. CBH will manage this issue as part of its strategy for responding to the new wheat marketing reforms.

The diagram below illustrates how competitive activity between traders using CBH country facilities needs to be excluded from the free to compete with the CBH supply chain by using private storage and road transport.

It should be noted that rural road transport freight prices probably include a hidden state subsidy in that the full cost of the provision of lightly used roads is not met via heavy vehicle registration charges.

It is likely that the State will require a higher contribution from users of future investments in State roads made specifically to accommodate the needs of the industry.

Figure 2 - Illustrative Supply Chain Structure



Under Grain Express, export grain in the CBH system need not be regulated to rail – road transport will be used in conjunction with rail under contractual terms and conditions. It would be CBH, however, that would manage and authorise the use of road transport under these terms, rather than the grain owner. The CBH rail contract will also need to be competitive with the non-CBH road-based chains in its own right.

The exact nature of the rail agreement requires some attention. To be successful, the contractual environment will need to satisfactorily address the following issues:

- maximise rail volume
- manage seasonality and drought risk
- road competitive pricing
- capacity for 'network' pricing
- joint accountability to customers
- equitable cargo assembly principles
- support managed road usage

A variation on the traditional fixed/variable pricing system may well be the best way to meet the criteria for success and long term rail viability. Under such a system, the fixed component of the annual rail freight bill would be met by users of the CBH system, while the variable component would be paid by traders, through a 'notional freight' arrangement. The variable component would usually be very competitive with road transport rates, once the fixed component had been met by the grower on delivery at harvest.

CBH needs to negotiate a suitable long term agreement with ARG and possibly WestNet Rail, with government agencies observing. Government would also need to develop a performance monitoring capability to ensure its objectives were being met through the course of the contract, particularly in relation to returns on any investment it makes in track and associated infrastructure.

Economic benefits

High level conceptual analysis of the benefits of Grain Express over a laissez-faire approach indicates that there are benefits in regard to grain handling costs, rail viability and efficiency, reduced road usage and in externality costs.

These benefits will arise from:

- much less grain handling activity at country sites through orderly programming of grain movements
- improved train asset utilisation through better planning and less failures
- leakage of considerable volumes to road avoided, thus protecting quality rail freight revenue
- potential managed use of defined road corridors, leading to maintenance savings
- reduced potential for heavy vehicle traffic on roads into ports, including Kwinana and MGC.

While the benefits are considered substantial (i.e. greater than \$10m per year), a more rigorous analysis would be needed to generate meaningful estimates.

Conclusions

The basic model whereby CBH holds a rail contract on behalf of the export traders using CBH facilities is clearly sound and is the appropriate direction for the industry to head, in order to maximise the viability of the rail operator and to reduce cargo assembly costs to growers.

The proposal to bundle all transport and storage and handling services for customers appears to have gained a degree of acceptance from the trade, particularly where combined with assurances on other aspects of the proposal. Bundling of transport services is the best means of providing the security that will be required by ARG under a CBH rail contract.

The change to rules regarding site entitlement for CBH customers as part of Grain Express is an essential component of the proposal. While this is a reasonable approach from a handling perspective, it will have major impacts on the current rights of traders, and will not be acceptable unless considerable changes are made in relation to, inter alia:

- Stocks information availability to all traders using the system
- Separation of CBH's trading business from the Operations arm
- Convergence of receipt and outloading standards
- Resolution of matters of detail between CBH and the trade, through WA NACMA

Private traders will require the same amount of information regarding traders' stocks in the system as CBH trading currently enjoys, in order that the perception of favourable treatment is addressed.

CBH will accept some responsibility for cargo assembly performance in recognition of its assumption of full responsibility for logistics chain management. To do this, CBH will need to introduce clearer prioritisation and performance protocols and to take contractual responsibility for aspects of demurrage/despatch and rail transport and silo performance. This will be a major philosophical step for the company.

CBH is essentially a bulk handler, and is set up to handle large consignments of grain for single export customers. It does not have any mandate to specifically foster the private trade to the extent that this trade fragments the export task and creates additional cost for growers. Under Grain Express, however, smaller and larger traders should be able to be serviced on an equitable basis, and competition between traders in their core competencies should not be threatened.

Grain Express provides an environment in which competition between traders **will** be based on their relative ability to accumulate grain from growers, charter sea-freight, and to sell to international buyers, rather than through finding an edge in landside supply chain costs. This **will** provide some long term stability to the freight contracting environment, and the rail sector in particular. Traders will still have the ability to compete with the CBH product through the use of on-farm and private storage, along with road transport. The CBH chain will therefore need to be efficient in order to retain market share against this sector.

CBH has had a tendency to send price signals to traders by imposing charges for certain services. Grain Express will give it more autonomy and this should mean it can revise its total charging practice and reduce the number of additional charges levied on its customers.

The alternative models identified in Section 2 of this report introduce relevant and significant 'interface' costs that would be additional to the cost structures inherent in the Grain Express proposal. They would thus add cost without necessarily providing additional service benefits. They could also result in lower rail volumes, thus increasing the fixed infrastructure cost components of freight rates for some users.

Subject to the ability of CBH to continue to negotiate the detail of the proposal with its customers, grower membership base and other stake-holders, Grain Express is therefore endorsed as the most appropriate basis for future export grain supply chain co-ordination in Western Australia.