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Dear Ms Dalins

# Co-operative Bulk Handling Limited (CBH) Exclusive Dealing Notification N93439 - Response to Request for Further Information

Thank you for your letter dated 5 May 2011. This letter:

- clarifies the number of destination sites where domestic outturns are provided by CBH and the configuration of road or rail weigh bridges at destination sites; and
- responds to the submission from Australian Railroad Group (ARG) which was provided to us on 6 May 2011.

## 1 Destination Sites

1.1 CBH offers the ability to nominate grain to a marketer at five "**Destination Sites**" - each of the four ports and the Metro Grain Centre (**MGC**). This nomination forms the basis of an entitlement to outturn grain at those sites and an assumption that grain of that quantity and quality will need to be moved to the Destination Site.

1.2 However, both the ACCC's question and CBH's answer require further clarification. CBH does not prohibit domestic outturn at non-destination sites and it is not correct to state that there are any particular sites at which a domestic outturn service is "*no longer available*". CBH has never refused any request for domestic outturn where it has been possible. CBH responds to requests for domestic outturn at other sites on a case by case basis and, in many cases, provides a service upon request. For example:

(i) in the 2009/2010 season, CBH outturned 506,986 tonnes of grain at 48 sites;

(ii) to date in the 2010/2011 season CBH has outturned 219,128 tonnes of grain from 36 sites.

1.3 Details of these outturns are provided in the attached **confidential** spreadsheet.

1.4 Rather than describing Destination Sites as the only places where domestic outturn was available, it is more accurate to describe the up-country Destination Sites as places where domestic outturn would always be available if grain had been nominated there, with other requests subject to the availability of labour and other resources.

1.5 As is explained in CBH's submission of 13 October 2009, the decision to reduce the number of Destination Sites was taken in direct response to a lack of consistent demand to nominate grain to sites other than the four ports and MGC. CBH could not justify applying resources to the provision of services at a large number of sites, without a clear history of demand that would justify that allocation.

(a) The ACCC's question appears to arise from a misreading of CBH's submission of 23 September 2010. The portion of CBH's submission of 23 September 2010 that is extracted in the ACCC's letter was a quote from an earlier submission. CBH's most recent statement on the number of Destination Sites, which appears in the submission dated 13 October 2009, stated the correct position and that remains the case.

1.6 The ACCC's question about domestic outturn sites illustrates an important aspect of the nature of likely demand for up-country outturns. This is a very important point. It would not be correct to assume that a revocation of the notification will create an opportunity for marketers to efficiently outturn grain from CBH's up country storage facilities. For reasons explained below, the kinds of outturns that may be facilitated by revocation are likely to be inefficient.

1.7 Revocation of the notification would bring about significant change from the consistent port-based export entitlement system operating under Grain Express to a system in which there is some port-based entitlement (where Grain Express is chosen) and some site-based entitlement (where grain is moved between CBH facilities by transport arranged by marketers).

1.8 This changes a marketer's likely stockholdings from a large volume holding at port (Grain Express) to many small volume holdings dispersed throughout storage facilities in the State (non-Grain Express). Unless a marketer acquires grain entitlement from growers adjacent to a particular site, it is unlikely that the marketer will hold sufficient grain volumes at a site to be able to outturn a large volume of grain from that site. This is supported by current domestic outturn volumes. Average domestic outturns at non-Destination sites are less than 1000 tonnes each, which is less than half the volume required to fill a train efficiently and a fraction of the 27,000 tonne capacity of an average vessel.

1.9 By contrast, when CBH moves grain from a receival point to port, it is able to outload grain in large volumes onto its Grain Express transporter (with Grain remaining in CBH custody and without weighing or testing).

1.10 Most likely, marketers wishing to bypass CBH will only be able to outturn small volumes of grain from up-country sites for transport to port. A few things flow from this:

(i) marketers will perform these small volume outturns only where there are short-term price advantages over Grain Express pricing but doing so will increase CBH's costs and lead to increased prices over the longer term;

(ii) small volume outturns also give rise to the externalities referred to in CBH's previous submissions, such as increased incidence of pest resistance caused by repeated re-gassing of storages when seals are broken to extract small volumes;

(iii) small volume outturns are likely to be onto road, because rail is simply unviable unless large volumes are involved and there are no rail weighbridge facilities at country sites in any event. That is one of the reasons why ARG's most recent submission is factually and logically flawed; and

(iv) site-based entitlement may have been workable prior to deregulation when there was only one large volume wheat exporter (AWB). Now that there are many marketers, a move back to partial or complete site based entitlement will necessarily increase supply chain costs.

In summary, revoking the notification may encourage firms to remove grain from CBH storage for the purpose of transporting it independently but these movements will be inefficient and cannot therefore be regarded as pro-competitive. The ACCC risks imposing increased supply chain costs for an illusory benefit.

## 2 Weighbridges

2.1 All CBH sites contain road weighbridges. No CBH sites contain rail weighbridges.

2.2 The reason why no rail weighbridges exist is that grain loaded onto rail was always owned by a single desk entity during transport to MGC or a port, where grain would be weighed upon outturn, either on the conveyor in a port terminal or when loaded onto a truck or into containers at MGC. With only one owner, one handler and one transporter, reconciliation of stocks was possible over time. With multiple owners and multiple transporters this reconciliation becomes more difficult.

2.3 Once again, this question illustrates an important point that may not previously have been appreciated by the ACCC. Revoking the notification without addressing this fact would be a substantial weakness in any ACCC decision as the lack of rail weighbridges at receival sites virtually guarantees that any outturns from CBH for independent transport will be onto road. The ACCC risks increasing heavy vehicle transport on WA regional roads in pursuit of a theoretical constraint on the pricing conduct of a non-profit cooperative.

## 3 Submission from Australian Railroad Group (ARG)

3.1 ARG's letter dated 2 May 2011 contains numerous assertions, very few of which are backed up by any factual information. This letter contains CBH's responses to ARG's assertions in 3 parts:

(i) Background to ARG's recent opposition to Grain Express;

(ii) ARG's assertions about the effect of the notified conduct on competition; and

(iii) ARG's assertions about the timing of revocation.

*Background to ARG's opposition to Grain Express*

(b) Until very recently, ARG has operated as the monopoly supplier of above rail grain freight services in Western Australia. Prior to the introduction of Grain Express in 2008, ARG supplied rail freight services under a long-term contract with AWB Limited, Grain Pool Pty Ltd (as it then was) and CBH. An important element of that agreement was a substantial fixed cost component in pricing, which was designed to provide ARG with the certainty it required to invest in rolling stock and other infrastructure requirements.

3.2 ARG was a supporter of the original Grain Express project when it was first introduced. In fact, ARG was strongly supportive of Grain Express up to and during the competitive tender process which took place in 2010. Announcing its participation in that competitive tender process, the Group General Manager of ARG Bulk West, Ken Potts (who is also the author of ARG's letter dated 2 May 2011) said:

> *"ARG is supportive of the Grain Express model and wants to increase the proportion of grain that is hauled to port on rail, and has committed to work with CBH to achieve that result."*

3.3 Mr Potts was also reported as having said that the increased certainty provided by a ten year term would enable ARG to increase its investment in modern and efficient locomotives.[1]

**3.4 Confidential paragraph redacted**

**3.5 Confidential paragraph redacted**

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3.6 ARG's opposition to Grain Express and the notified conduct commenced on 13 December 2010, when CBH announced that a new entrant (Watco Companies) would replace ARG as the contracted supplier of rail services to CBH from April 2012.

*Effect on competition*

[1] WA Business News 30 June 2010; Railpage Australia and New Zealand "*ARG joins grain rail tender*" www.railpage.com.au/news-7928htm

3.7 CBH's tender process for rail grain freight services was the first ever competitive tender process for the supply of these services. CBH was successful in attracting bids from ARG's competitors because it was able to offer the successful tenderer a sufficient degree of certainty of volume to justify a substantial capital investment required for new market entry. This simply would not have been possible without Grain Express and the notified conduct.

3.8 Against this background, it is interesting that ARG would state:

> *"The revocation of Grain Express will allow ARG substantial grain fleet of up to 27 locomotives and 667 bulk grain wagons to compete in the grain freight services market."*

3.9 The remarkable thing about this statement is that it ignores the fact that ARG's fleet competed in the grain freight services market when ARG participated in the competitive tender process against Watco and other bidders in 2010. It would be more accurate to say that ARG, having lost that competitive tender, now asks the ACCC to revoke the notification in the hope that doing so may provide ARG another chance that it did not earn. This would not be regulation to promote market competition; it would be regulation to reverse the outcome of a competitive process.

3.10 The premise underlying ARG's submissions is that the replacement of ARG as the supplier to CBH (with the resulting redeployment or retirement of ARG's rail assets) necessarily means that Grain Express and the notified conduct substantially lessen competition in rail. However, had ARG won the CBH tender, there would still have been only one current supplier of rail freight services to CBH. ARG would hardly be complaining had that occurred. ARG's interest is not in promoting competition.

3.11 Rather than lessening transport competition, Grain Express has facilitated the new entry of Watco following a heavily contested competitive tender process. ARG's submissions ignore this and focus almost exclusively on ARG's corporate self-interest. There is no analysis of market structure and no description of exactly how ARG proposes to efficiently supply services after the revocation if, as is pointed out above, only small volume outturns onto road are likely to be possible following any revocation.

3.12 ARG's primary argument is that revocation of the notification would allow ARG to compete in the grain freight services market. This suggests that ARG contends that without a revocation, ARG is unable to compete.

3.13 Competition with and without the notified conduct is not an all or nothing comparison. On any fair assessment, substantial competition will take place both with and without the notification in place. Assessing the likely effect of notified conduct requires consideration, not of the number of competitors supplying services in a market at any time, but of the source, nature and efficacy of competition with and without the conduct. This means that the ACCC's decision must address the relevance of CBH's tender process as a competitive process and assess whether the kind of transport competition that may be promoted by revocation is more or less efficient.

3.14 Revoking the notification may, as the ACCC's draft notice suggests, promote one form of competition in grain transport – where a marketer outturns grain from CBH's up-country storage, transports it to port independently, and then re-deposits the grain into CBH storage at port. As is explained above, this form of competition is inefficient and likely to increase overall supply chain costs. In reality, competition in transportation may occur with the notified conduct in several other ways, including.

- Growers and marketers choose where in the CBH supply chain to deliver their grain[2]. In doing so, they effectively substitute their own road transport for CBH's road or rail service. The ability for growers or marketers to put grain into the CBH system at or closer to port represents a substantial competitive constraint on the bundled Grain Express offer.
- New entry in storage and handling (by the construction of new storage facilities at viable up-country locations) may enable a complete (and potentially efficient) bypass of the CBH up-country network[3]. As the Productivity Commission and Frontier Economics have pointed out, up-country storage facilities are duplicable. A new storage & handling entrant would be in a position to contract with a rail freight provider for large volume efficient movements of grain to port, taking advantage of the regulated port terminal service available under CBH's access undertaking. Unlike the partial bypass of Grain Express that revocation would promote, this more complete form of bypass might actually be efficient and pro-competitive. However, and somewhat ironically, revocation would significantly **reduce** the incentives for this efficient form of competition because potential storage and handling entrants (such as marketers) may delay investment in favour of inefficient partial bypass.

3.15 The use of tenders to promote competition "*for the market*" in rail markets has been the subject of significant economic research and analysis[4]. In assessing rail markets, regulators must address a difficult problem – not ***if*** but ***how*** to promote competition in such a way that scale and scope efficiencies are not squandered.

3.16 In the case of grain transportation in Western Australia, CBH tenders are not really "*for the market*", but really for the business of the market's largest current

[2] See Frontier Economics February 2011 report pages 1-3.
[3] This kind of entry is what CBH expected would be promoted by the access undertakings that were mandated by section 24 of the Wheat Export Marketing Act.
[4] See, for example, Kain, P 2006 "The Pitfalls In Competitive Tendering: Addressing The Risks Revealed By Experience In Australia And Britain"; Stanta & Galli 2005 "Local Railway Tenders In Italy: The Impossible Competition"; Macário R., J.M. Viegas, D.A. Hensher (editors) (2006) Competition and Ownership in Land Passenger Transport Selected Papers from the 9th International Conference,, Lisbon, September 2005. Elsevier/Emerald; Gunnar Alexandersson & Staffan Hultén – "Competitive Tendering of Railway Services in Sweden Extent and Effects 1989-1999"

customer. However, with the notification in place, CBH is able to run tender processes that offer a relatively high level of certainty of scale to the successful tenderer. Revocation would significantly reduce that certainty because CBH would be unable to reliably predict the extent of "partial bypass" onto road transport.

3.17 ARG also claims that rail freight resources will leave the market permanently, as if rolling stock never relocates in response to competitive opportunities. In fact, ARG's parent entity is in the process of moving Western Australian based grain rolling stock to New South Wales after winning a three year contract to supply services to Glencore[5]. ARG announced this on 11 April 2011 but its letter to the ACCC dated 2 May 2011 omits any mention of it. The movement of these assets demonstrates the mobility of grain rail freight assets and the resulting constraint on incumbent suppliers in Western Australia.

*Timing of revocation*

3.18 ARG's submissions on the timing of revocation also suffer from a near complete lack of data and an insistence that CBH should have treated the ACCC's Draft Notice as a final decision. ARG's errors and omissions in this part of its submission include the following.

3.19 At paragraphs 4, 5, and 17, ARG states that any delay in revocation will result in the demise of ARG's Western Australian grain freight operation and the complete loss of ARG as a competitive constraint in rail freight. No evidence is provided in support of this assertion and ARG's recent conduct in relocating rail assets to NSW significantly undermines its credibility. Watco's entry is itself proof that new entry in pursuit of a competitive opportunity has occurred under Grain Express.

3.20 At paragraphs 5 and 6, ARG suggest that CBH should have been planning for revocation since the issue of the ACCC's Draft Notice. While CBH has naturally engaged in some contingency planning, much of the systemic change required to implement a site-based entitlement system alongside a port based entitlement system for Grain Express (the bundle) requires a substantial investment of time and resources or requires the participation of third parties. CBH cannot be expected to incur these costs at the draft decision phase, effectively treating a draft decision as final.

3.21 At paragraph 6 and 12, ARG states that revocation will operationally revert CBH back to pre-1998 circumstances. This is entirely and obviously false. In 1998, bulk wheat was exported under the single desk monopoly system and barley, canola and lupins were exported by the Grain Pool of WA (a state based single desk). The monopoly exporters were able to move large volumes of grain between country and port and were able to contract with transport suppliers on a whole of system basis with high certainty of volume[6].

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[5] QR Press Release 11 April 2011 states "Rollingstock is being redeployed to New South Wales from QR National's Western Australian operations."
[6] That system was imperfect but at least enabled some scale benefits and relative operational simplicity.

3.22 Grain Express was a direct response to the fact that, with deregulation, grain entitlement would be fragmented, so a site-based entitlement system with transport arranged by marketers would no longer be efficient or manageable. As CBH has previously stated, revocation will result in CBH providing for two entitlement systems – a port-based entitlement system under Grain Express and a site-based entitlement system to the extent that marketers wish to engage in the inefficient partial bypass that the ACCC's Draft Notice appears to support. This duplication of entitlement systems with small-scale transport contracts is nothing like the system that existed prior to Grain Express.

3.23 Paragraphs 7 and 17 refer to ARG's current contract with CBH. It is not surprising that ARG wishes to continue to perform that agreement after revocation without amending the terms. ARG wishes to be paid the fixed term price component of tariffs (which were negotiated on the assumption that Grain Express would remain in place) while at the same time promoting a regulatory decision that would reduce the volume of grain supplied through that contract, thus increasing CBH's cost per tonne and threatening the viability of CBH's transport operations. That is not competition, it is opportunism. It is crucial that the ACCC properly understands the effect of the current ARG agreement with CBH. If the ACCC is in any doubt on this point, CBH can provide further information and, if necessary, have one of its rail logistics managers explain the effect of the agreement in detail.

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3.24 Finally, paragraph 18 contains a request for price regulation to prevent predatory pricing. The ACCC should see this for what it is – a request for the competition regulator to increase prices to protect the narrow self-interest of a particular competitor.

Yours sincerely

**Bill Keane**
Partner