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2009 Rail Access Regime Inquiry

SUBMISSION OF GYPSUM RESOURCES OF AUSTRALIA PTY LTD

Summary

The terms of reference for the inquiry are broadly that ESCOSA advise on amendments to the state rail access regime so that the regime would comply with the framework for access regimes in the Competition and Infrastructure Reform Agreement of 10 February 2006 and that ESCOSA advise on any other changes to the access regime that may improve its overall effectiveness.

Gypsum Resources Australia (GRA) as a significant user of the intrastate rail network submits that in its experience:

- GRA has paid a fair price for access over the past ten years, which should have provided for the asset to be maintained, however, is now being asked to pay again to perform "catch up" maintenance, i.e. the current regime does not commit the access provider to properly maintain the asset.
- the current arrangement provides for a monopoly rate of return.
- there is no incentive for the vertically integrated operator to perform efficiently in the current regime.
- the provision in the CIRA framework for price monitoring be reflected in the South Australian rail access regime so that investment required and carried out for particular sections of railway is transparent.
- the regime as currently constituted favours the vertically integrated incumbent. i.e. it does not promote competition

GRA does not believe that the regulatory regime around third party access solves the fundamental economic problems with maintaining the competitive position of rail transport. In particular it does not improve the supply chain efficiency of SA regional rail transport and dependent industries such as GRA's mining operations.

This needs to be addressed by a structural industry reform which encourages economic efficiency and includes external benefits such as carbon emissions, environmental impact and community road maintenance and operations costs.

Background GRA's use of the Kevin – Thevenard Railway

GRA mines gypsum at Kevin which is sold onto domestic and export markets. Whilst this is a large deposit of high purity, gypsum is a common mineral and GRA and the downstream Australian based manufacturing processes of its parent companies are subject to intense international competition both in terms of input material and finished product supply.

GRA's gypsum is hauled on Genesee and Wyoming Australia's (G&WA) 66 kilometre railway from Kevin to Port of Thevenard. This is the only traffic on the railway and the railway should be the most attractive means of hauling the gypsum to port. However the rail transport option is not meeting GRA's expectations for a low risk supply chain or productivity improvement commensurate with long term sustainability.

In the 12 months to March 2009 approximately 1.8 million tonnes of gypsum were mined and hauled to port. The annual tonnage mined and hauled has steadily grown over the past ten years in line with GDP.

G&WA's only source of income for the railway is GRA. Other mineral developments (Cheetham Salt and Iluka) in the area have opted for road transport as a solution because of the high cost base of the current commercially obsolete rail operation.

GRA has obtained pricing for access to the railway line between Kevin and Thevenard in 2007 with a view to obtaining competitive quotations for the provision of rail haulage services. GRA had a 10 year haulage agreement with G&WA and its predecessors. This has recently expired and negotiations have been underway for over three years on a new rail haulage agreement which included upgrading below rail assets to improve productivity.

Addendum, Section 1 contains details of the GRA Business and its competitive position.

Comments on the Inquiry Terms of Reference

As GRA is required to contract with G&WA either for the haulage of the gypsum **or** for access to the railway, a right to arbitration (the essential feature of an access regime) to set the terms of the contract is required if the terms cannot be agreed. The present inquiry touches on that right and directly concerns GRA. This is the reason for GRA making this submission.

Specific Comments GRA has concerning the issues raised in the ESCOSA paper are as follows:

Terms of Reference 2.1 The parties agree to establish a simpler and consistent national approach to economic regulation of significant infrastructure

The principles which underpin the current regime are fairly narrow in focus and do not currently consider the economics of providing access to a transport facility which has competition from other modes and requires an upgrade to improve its productivity.

In GRA's experience the Current Access Regime is not encouraging the rail transport option to achieve competitiveness, particularly as in this case where GRA's competition is characterised by logistics chains with a lower labour cost (Thailand), or that rely on a shorter road haul distance and sea freight (Dampier Salt W.A.).

Outcomes of the current regime do not appear to promote an economic investment to keep the freight flow on rail (and thereby reduce the maintenance and renewal cost associated with the road network) rather it maintains a favouritism towards shifting the task to road in the short term and exposing the entire operation to future risk should the price of carbon or fuel increase.

Terms of Reference 2.2 Third Party Access to Services Provided by means of Significant Infrastructure Facilities should be on the basis of terms and conditions commercially agreed between the access seeker and the operator of the Infrastructure

The provision of regional rail infrastructure in Australia has always relied on consideration of "economic" benefits rather than purely commercial accounting benefits. As a result third party access suffers from the imposition of a commercial framework driven by the need to provide short term returns to shareholders of access providers.

In the case of the SA Regional Rail Network there is a relatively low product volume and consequently long periods of time are required to recoup any investment. This is not usually acceptable to the shareholders of any company listed on the stock exchange as they require as shorter period as possible in which to see a return on their investment.

In addition, the operator of the rail infrastructure is also not necessarily in a position to reap advantage from all of the economic benefits that rail transport brings including:

- Lower road network maintenance costs;
- Reduced Carbon emissions; and
- Reduced number of heavy vehicle accidents.

Terms of Reference 2.3 The Introduction of Price Monitoring for services provided by means of significant infrastructure facilities should be considered, where this would improve the level of price transparency

GRA's experience is that the current regime fails to provide for either price transparency or protect GRA from the access provider structuring their offer to cover inefficiency in the above rail operation by increasing its below rail price.

However, price monitoring by itself is unlikely to prevent the access provider's current commercial behaviour which has been to charge GRA a reasonable sum for the maintenance of the track yet spend only a fraction of that amount on the track each year.

GRA believes that to operate successfully the access regime should at least provide sufficient funds for the access provider to maintain the track. However, in the case of the rail infrastructure between Kevin and Thevenard, the access provider has chosen not to use these funds for this purpose but rather to take them as profit. As a consequence the above rail cost base has increased through additional fuel usage, crew time and higher rollingstock wear rates and GRA is being asked to pay again through an increase in access charges for the deferred maintenance work on the below rail asset and also the resulting higher above rail costs.

The current pricing regime requires an assessment of what would constitute a "prudent" level of maintenance and in the absence of a set of mutually agreed set of infrastructure standards this would appear difficult to define.

In contrast ARTC provide details on their website of the standards applying to the asset, the asset performance, each line segment DORC, the access price, the ceiling and floor limits and the maintenance and proposed capital expenditure for each line segment. This provides a reasonable level of expectation that other access providers should do the same or at least be able to provide these details as part of an access price negotiation. In GRA's experience with the intrastate access provider this is not the case with several aspects of this information unavailable or inconsistent.

Area's in the current regime which have discouraged GRA from pursuing an access pricing dispute are:

- the definition of "prudent" or efficient operation which is difficult to establish without readily published and accessible benchmarks; and
- the degree to which there may be room for interpretation in the calculation of the valuation of the regulatory asset base and the depreciated optimised replacement cost (DORC) calculation.

GRA's interpretation of the correct DORC calculation methodology is that correctly applied it should not reward the access provider for starving the asset of renewal funding as the access ceiling price would be lower. An increase in the transparency of pricing would greatly assist the process of obtaining rail access and ensure that adequate provision is being made for maintenance and renewals.

Addendum, Section 2 contains GRA's suggestions for enhancements to the price monitoring regime. A summary of issues surrounding the line condition are contained in Addendum, Section 5.

Terms of Reference 2.4 Consistent Regulatory Principles

(a) Objects clauses that promote economically efficient use of, operation and investment in significant infrastructure thereby promoting effective competition in upstream or downstream markets.

GRA believes that the operation of the current rail access regime encourages the access providers downstream above rail services to remain inefficient both from itself having inefficient sources of supply on long term contracts with little apparent incentives to perform and having commercially obsolete equipment. This does not promote effective competition rather to the contrary is protecting an inefficient above rail provider who would otherwise lose the business.

Effective above rail competition is prevented by the fact that the track infrastructure has been allowed to deteriorate to such a point where GRA suspects that the access provider is pricing in a “risk” premium for any other operator other than its own above rail vertically integrated operation to access the asset.

As other railways in Australia improve productivity GRA's access provider's vertically integrated above rail operator is one of the few operators with 12 t axle load locomotives, the average age of which is around 40 years. The restriction of the line to 12 t axle load is a barrier to entry to an operator with a more modern and productive fleet and hardly promotes the use of the currently produced narrow gauge locomotives which are twice as powerful (one of the units in current production would replace three of the units in operation on GRA's gypsum haulage). Of equal concern is that at some point in the future, say in 10 years time, the locomotives supplied by G&WA will be life expired and uneconomic to replace posing a significant supply chain risk to GRA.

G&WA's track maintenance provider also enjoys protection from competitive pressure as a result of the pricing principles as there is no mechanism for cost transparency against an industry benchmark.

(b) Regulated Prices Should be Set so as to: -

GRA's experience of the outcomes generated by the current access regime is that it fails three of the four criteria listed for effective price regulation namely.

1. Generate a return to cover the costs of providing an efficient service

By GRA's calculations the haulage charges paid over the last contract period and previously should adequately cover the costs of providing an efficient service including the ongoing like for like renewal requirements of the infrastructure assets.

However, due to the fact that GRA utilises a “single user line”, the current access provider has to write off the capital expenditure within the period of the contract (5-10 years) rather than over the life of an asset (typically 50 – 80 years in the case of modern track infrastructure components). This is creating the circumstance where the asset has been starved of the capital funds required not only to maintain the current service level but to ensure productivity improvement.

As a result the current service level has declined requiring the imposition of severe temporary speed restrictions this in turn is leading to an increase in operating cost and the use of suboptimal renewal technologies and strategy.

2. *Allow price discrimination when it suits efficiency*

Given the line has only a single user this does not appear relevant to GRA.

3. *Not allow a vertically integrated access provider to set terms and conditions which would favour their operation*

GRA's experience is exactly the opposite in that the vertically integrated access provider has managed to successfully set terms and conditions for access which has favoured their own above rail operation in particular:

- The addition of an unduly large "risk" component to the price so that additional maintenance expenditure is required to operate a third party than their own trains.
- The lack of a defined and implemented standard for track maintenance practices which means a new entrant cannot adequately price the risk of operating rollingstock over the asset.
- Inconsistent application of training and accreditation requirements.

4. *Provide incentives to reduce costs or otherwise improve productivity*

GRA's experience is in fact directly the opposite of this requirement as the access provider has consistently refused to pass on the savings from above rail productivity gains arising out of below rail investment.

As outlined previously, this includes the basic maintenance requirements associated with investing in timber component renewal to enable the asset to perform as designed as well as infrastructure upgrading to allow equipment to operate which is consistent with basic rail industry norms for productivity currently a minimum of 23 tonne axle load in South Australia and 25 or 30 tonne axle load elsewhere in Australia for bulk commodity transport on the Defined Interstate Network.

In contrast, the current operation is limited to 12 tonne axle loads, which is only just marginally more efficient than current road transport technologies and less efficient than high productivity road vehicles.

The decline in asset productivity can be measured by the reduction in maximum line operating speed from 60 km/h in 1997 at the start of the contract with G&WA to the current proposal of 30 km/h.

Other Factors

Access to Other Infrastructure

GRA's experience is that the ancillary infrastructure such as the ownership of servicing facilities and associated track presents another hurdle to be overcome in gaining access to the SA intrastate rail network.

This would not be as bad if the network itself were owned by a third party and other providers were able to establish facilities.

Provision of Information (S4.2.2)

GRA has been provided with an information brochure by G&WA. The information in the brochure was inaccurate, incomplete and changeable during negotiations.

Inaccurate items included:

- The published allowable axle loading on the line;
- The line upgrade proposals; and
- The line transit time (currently substantially slower than the published time).

Missing items included amongst other things any details behind the basis of calculation of the ceiling and floor prices and the value of and means of calculation of the Depreciated Optimised Replacement Cost (which appeared extremely high given the line condition, previous capital expenditure and age when compared with ARTC's published line segment values for the interstate network).

Items which changed included:

- The ceiling price; and,
- The line upgrade required to achieve a given level of productivity improvement.

Detailed commentary on the deficiencies found in the information brochure is contained in Addendum Section 3.

Negotiation (S4.2.3)

GRA has been negotiating in good faith with the integrated rail haulage provider for over three years. The progress of the negotiations is summarised in Addendum Section 4.

GRA's experience is that the current act fails to adequately structure a negotiation process or explicitly provide for transparency between above and below rail pricing. Whilst in keeping with the need to maintain flexibility it does not allow a sufficiently structured process to force a timely outcome.

GRA's negotiation process over this time has included:

- Benchmarking mineral haulage operations and the derivation of a rail cost model; and
- Testing the market to introduce competitive tension.

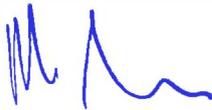
Conclusion

GRA does not believe that the current rail access framework provides sufficient incentive for the access provider to deliver productivity improvements required to maintain rail transport's competitive advantage or the required competitive advantage to GRA's business from low cost based overseas and interstate gypsum supply competition.

Indeed it may be argued that any access regime can be manipulated by a vertically integrated access provider to favour its own operation. Hence this is a long way off a goal to promote economic efficiency and adhere to competition principles of having access to the rail network on the same terms as access to the road network.

GRA believes that the regulatory regime around third party access does **not** solve the fundamental economic problems with maintaining the competitive position of rail transport versus other modes (trucking) and GRA's competitors. This needs to be addressed by a structural industry reform particularly on "single user lines". This would encourage economic efficiency and include all external benefits such as carbon emissions, environmental impact and community road maintenance and operations costs.

I would welcome the opportunity to meet face to face to discuss our submission.



A Kelsh
General Manager
31 March 2009