Committee for the Economic Development of Australia
Queensland Rail Divestment Process: Treasurer's Update
Brisbane Convention and Exhibition Centre
14 May 2010

QR Divestment – the case for a different model

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Thank you Robert (Fuller) for your introduction and can I begin by acknowledging the traditional owners of the land that we meet upon today.

Let me also acknowledge the Honourable Andrew Fraser MP, Queensland Treasurer and Dr Vince FitzGerald, who you have just heard outlining the case for maximising the long-term benefit for Queensland from the QR divestment process.

I can say without hesitation that there is unanimous support in this room and throughout the state for that objective. It is how we get there that has made for a robust debate and at times, I imagine a confusing spectacle for many Queenslanders.

Political tensions have been high, and that's why we are grateful for the opportunity provided by CEDA today to excise the emotion from this issue.

The privatisation of QR National's above-rail freight business – along with the below-rail coal track network servicing the state's leading export industry – means that every Queenslander has a stake in this sale.

The coal industry was worth $38 billion to Queensland last financial year. That's the direct value of production, excluding the flow on to the Queensland economy, government revenues and regional communities.

Subject to the fate of the federal government's super tax on the resource sector, it's an industry planning to invest tens of billions of dollars more over coming years in start-ups and expansions to existing operations.

One of the most critical components in the development and maintenance of a globally competitive industry is its export supply chain. As we learned to the state and nation's detriment only a few years ago, export supply chain capacity is the difference between maximising our opportunities or losing hard-won markets to competitors.

No-one should be in any doubt over the importance to the Queensland economy of an efficient, responsive and globally competitive export coal industry.

Today, I am <u>not</u> here on behalf of the Queensland Coal Industry Rail Group – the consortium of 13 coal mining companies currently finalising an alternative financial offer to the government's proposed public float of a vertically integrated QR National later this year.

What I can say is that the consortium will have some important announcements to make in coming days. And what I can tell you about today is the thinking behind the formation of the consortium.

It should be evident that the coal industry and the Queensland economy's interests are best served by maximising coal exports. Increased exports mean more royalties and jobs.

What I want to leave with you today is the clear message that industry ownership of the coal rail track network is the best way to achieve that. What the consortium has said from the outset is that Queensland coal producers want the opportunity to put forward an industry offer and have it fairly considered by the state government.

As the peak representative body for minerals and energy companies in this state, the Queensland Resources Council has long held concerns over the vertically-integrated nature of QR's coal rail business.

Long before the government's divestment announcement last June, QRC has consistently argued for a separation of the coal trains and coal track businesses in the interests of transparency, efficiency and customer responsiveness.

The QRC and its members – including all the state's major coal producers – did not advocate QR privatisation but nor are we opposed – provided that it is properly structured.

However, they are united in their opposition to the sale of an integrated QR National combining coal track assets and haulage operations under one company, as currently proposed by the government.

QR National is the last of Australia's multi-user vertically-integrated rail businesses.

Elsewhere in the country, vertically integrated operations such as in the Hunter Valley coal rail system have been broken up. Operations in the Hunter are clearly the example most relevant to Queensland.

The above-track competition in the Hunter Valley is strong and includes QR competing quite successfully against private operators. The track network along which these competing coal haulage operators move their freight is owned and operated by a third party – the Federal Government's Australian Rail Track Corporation.

Competition in the above-rail sector is not only good for industry but also the state as a whole.

The structural separation of QR's essentially contestable above-rail coal haulage operations from the monopoly below-rail track business precludes the ability of an integrated rail business to stymie above rail competition...and promotes investment.

It is essential that the monopoly coal track business be in the hands of an owner whose interests are aligned with those of the coal companies. Government is one such aligned owner because of its interest in maximising jobs and royalties. When government vacates this space, the next obvious owners are the coal companies themselves.

They will be an owner interested in maximising the performance of the coal supply chain, not an owner interested solely in maximising profit from control of that supply chain.

The worst case scenario for the coal industry would be a non-aligned owner such as a publicly floated and vertically integrated QR. And that's what is currently being proposed.

Six months before the announcement of the public float last December, the Premier told Parliament that the sale process would focus on 'maximising the efficiency of our rail-to-port network' and 'providing a greater return in royalties to the people of Queensland.'

Frankly, no-one in the coal industry can imagine how either of these goals can be achieved under the state government's preferred model.

Private investors are being offered monopoly control of the track and ownership of one of the competing freight services requiring access to that track.

The coal industry's ownership of the QR coal track business makes sense. It is the coal industry that has the incentive to ensure timely investment in expansion of and maintenance of the network.

It is that timely investment that will ensure delivery of thousands of new jobs and hundreds of millions of dollars in additional royalties.

The state government has an obligation to test whether an industry-led consortium could deliver superior value to the owners of these assets – the citizens of Queensland.
Not only might the coal industry deliver a superior sale price, but also an owner fully focused on track network performance, investment, cost and reliability.

The last thing the coal industry wants is the entrenching of transport inefficiencies that it has had to endure for the past five years. The coal industry is also mindful that its ownership of the track network must work for small producers, new entrants..and protect the existing rights of non-coal users.

The government and QR management have been forthright in pointing out the supposed pitfalls of separation and the supposed benefits of railway ownership models both here and overseas, particularly in North America.

In defence of a privately owned and vertically-integrated QR National, Rio Tinto and BHP Billiton's West Australian iron ore rail operations have been cited on numerous occasions.

How can industry complain about a vertically integrated QR when your own companies operate the identical model in the Pilbara? The comparisons end fairly abruptly.

The owners of the Pilbara's mines are also owners of the rail. They are the perfectly aligned owners I spoke of earlier. In Queensland, QR is only part of the supply chain and there are a large number of different users.

Industry ownership of the track would in fact provide a viable comparison to the Pilbara – and this is exactly what is being proposed in Queensland. Put another way, QR does not own any coal mines.

Looking overseas, particularly at North America, we've been told that there are some excellent examples there of where the integrated rail ownership model is a big winner.

The question though is who is the big winner?

Warren Buffett is known as the best investor in the world and he's just spent 26 billion dollars buying the Burlington Northern Santa Fe railway company in the United States. A 'bedrock' Buffett investment principle is that companies must have a 'durable competitive advantage' that gives them barriers to entry and pricing power. Burlington Northern railway ticks all the boxes.

It owns more than 20,000 miles of track in the US and Canada, and it owns or leases more than 85,000 rail cars and 23 facilities dedicated to handling distribution of automobiles.

Now – as admiring investment commentators have noted – it is using that position to force rate increases on customers. Its earnings were up more than 25 per cent last year, thanks in part to a 15 per cent boost in freight revenue – two thirds of which came from price increases.

Warren Buffett knows his 'durable competitive advantage' better than anyone.

The facts are that the rail system in the USA is in no way comparable with that of Queensland. The US system comprises a series of geographic rail monopolies operating under weak regulatory frameworks.

This all makes for unhappy customers, particularly coal companies. Just ask Rio Tinto about its experience, and why it decided to sell down its coal interests in the Powder River Basin.

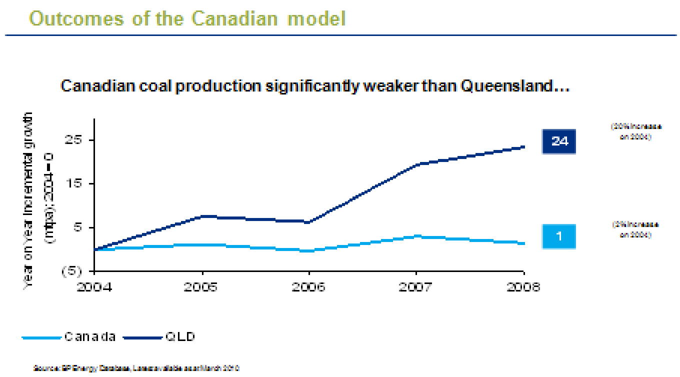
Based on the performance of the Canadian rail system, it's difficult to understand why it's quoted so often as a worthy template. Canada has essentially two vertically integrated rail companies. Canadian National and Canadian Pacific are general rail freight businesses. They are not primarily engaged in hauling coal, which as we know is the situation on the coal network in central Queensland.

The Canadian National privatisation has been held out as some wonderful template for QR's privatisation. Those advocates here in Queensland again forgot to talk to the Canadian rail customers.

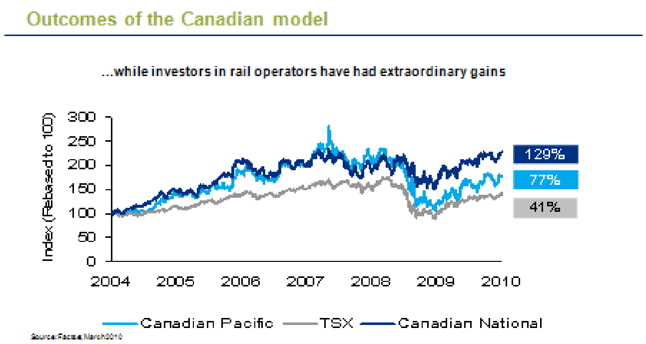
Canada's largest mining house – Teck – owns the world's second largest exporter of coking coal, Elk Valley Coal. Here is what that company says about the Canadian rail system:

'Elk Valley mines are entirely dependent on rail to transport coal to its customers… There is no competition for rail services at any of Elk Valley's mines. Each mine is captive to the carrier that serves it…Businesses such as Elk Valley are held back from competing due to the exercise of railway market power.'

So what's the upshot of strategies such as the exercise of railway market power?



From this chart you can see that the bottom line is that the Canadian coal industry has not expanded its operations to any real extent since 2004 when the global resources industry was experiencing major growth.



And from this chart you can see that the major beneficiaries of arrangements in Canada – surprise, surprise – have been the rail companies themselves, which have significantly increased their share price and capitalisation to the detriment of the coal industry.

The incentive for the currently proposed integrated QR business to delay critical infrastructure investment and restrict competition is very clear.

As things stand, in the absence of a customer-aligned ownership and structure, the coal industry will have to rely on a 'second best' policy response to mitigate the worst aspects of the proposed QR privatisation model.

The coal industry will be asking the Queensland Competition Authority (QCA) and the government to impose a brace of strict regulatory protections within the access regime and the formal lease documents. We will also be seeking supporting amendments to the QCA Act.

The access regime issue is a framework for third-party access to the rail network, which is very different from addressing incentives to misuse monopoly power.

Industry will need a regulatory regime in place that addresses the perverse incentives for a non-aligned, vertically integrated railway business to abuse its monopoly power at the expense of third-party operators and coal industry operations.

The current competition watchdog for QR *is* the state government and if QR is sold in its current form, it will not have control over uncompetitive behaviour. Without substantial amendment to the current regulatory framework, a privatised QR will have the incentive and means to profit at the expense of competition and industry growth.

If an integrated QR sale proceeds, the state government must have a safety net installed for future coal industry growth within the conditions attached to the lease agreement for the below-rail network. This is an important role for government, not just the regulator.

Such protections in the lease document will ensure that prospective buyers are educated quickly in the operational and competitive complexities of these critical export assets.

Formal obligations for the new company to invest in critical export infrastructure will be essential for industry to avoid further unnecessary project delays, characterised by the Goonyella-Abbot Point Expansion project – the so-called Northern Missing Link.

QRC will be seeking these investment protections in the access regime, backed up by amendments to the QCA Act to ensure these protections can be enforced.

Let me repeat that these protections should be built into the lease document.

What the coal industry and Queensland can't afford to see is the:

- Withholding of investment while seeking unreasonable contractual terms and conditions

- the demand for so-called "commercial" rates of return, while ensuring that all risks are carried by the customers

- a failure to maintain the rail network to an adequate standard, and

- the hindering, stifling and manipulating of the regulatory regime to effectively reduce competition and extract super-monopoly profits.

As you can see, the reliance on regulatory protections is messy and very much second best when compared with the simplicity of genuine separation of the above and below rail businesses.

I might note the state government's approach to that other vertically integrated beast – Telstra.

In that instance, separation was the mantra. Here is what the Queensland submission to the Productivity Commission said:

'With vertical structural separation, there are greater incentives on a network to increase throughput and incentives to provide favourable treatment to one retailer over another are eliminated.'

I could not have put it better myself. I would like you – and importantly, the Treasurer – to leave here today with a couple of key messages.

One – there is a compelling case for industry ownership of the coal network.

Two – all the coal industry is asking is fair consideration by the government of the offer that it puts on the table.

I know Treasurer; the offer has not arrived yet, but be patient. As we know, the better things in life are worth waiting for.

ENDS