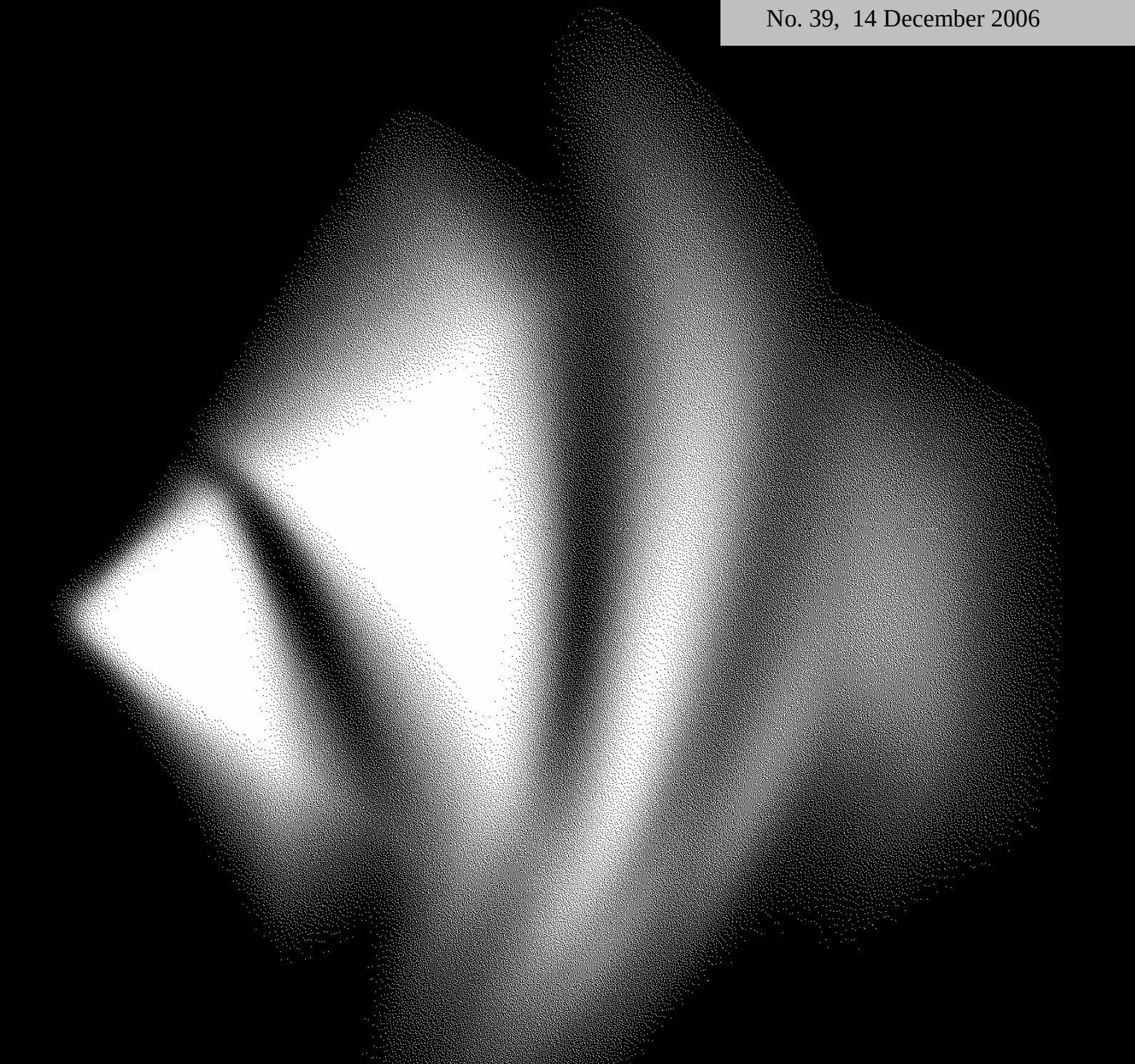
Australian Government
Productivity Commission

Tasmanian Freight Subsidy Arrangements

Productivity Commission Inquiry Report

No. 39, 14 December 2006



ISSN 1447 1329
ISBN 978 1 74037 217 6

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An appropriate citation for this paper is:

Productivity Commission 2006, *Tasmanian Freight Subsidy Arrangements*, Report no. 39, Canberra.

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The Productivity Commission, an independent agency, is the Australian Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

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The Honourable Peter Costello MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, I have pleasure in submitting to you the Commission's report on *Tasmanian Freight Subsidy Arrangements*.

Yours sincerely

Mike Woods
Presiding Commissioner

Terms of reference

INQUIRY INTO THE SUBSIDISATION OF CONTAINERISED AND BULK SHIPPING BETWEEN THE MAINLAND AND TASMANIA

Productivity Commission Act 1998

I, CHRIS PEARCE, Parliamentary Secretary to the Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby refer the current arrangements for subsidising containerised and bulk shipping between the mainland and Tasmania to the Commission for inquiry and report within nine months of receipt of this reference. The Commission is to hold hearings for the purpose of the inquiry.

Background

1. The Tasmanian Freight Equalisation Scheme (TFES) was introduced in 1976. The Government's objective was to establish a cost equalisation scheme to alleviate the freight cost disadvantage incurred by shippers of eligible non-bulk goods moved between the mainland and Tasmania by sea. Since its introduction, the TFES and its subsidy rates have undergone review on several occasions, in particular in 1985 and 1998. A key recommendation of the 1998 review of TFES was that the key assistance parameters for TFES should be reviewed annually and indexation adjustments applied as sea freight disadvantage changed over time.

2. The Tasmanian Wheat Freight Subsidy Scheme (TWFSS) was introduced in 1989, coinciding with the deregulation of the Australian domestic wheat market and replacing the Tasmanian Wheat Freight Levy which had existed since 1959. In the 2004-05 Budget, the TWFSS was ceased with eligibility criteria for the TFES being extended to include containerised shipments of wheat. The Government subsequently introduced the Tasmanian Wheat Freight Scheme (TWFS) for bulk wheat shipments from 1 July 2004, with containerised wheat to remain eligible for assistance via the TFES.

3. The Government wishes to undertake an independent review of these arrangements to consider the extent of the continuing benefits as well as costs of these schemes.

Scope of Inquiry

4. The Commission is to report on the merits and weaknesses of the current arrangements for subsidising containerised and bulk shipping between the mainland and Tasmania and provide recommendations on an appropriate future approach and/or arrangements.

5. In making assessments in relation to matters in paragraph 4, the report of the Commission should:

    a. Report on the characteristics of the freight task for containerised and bulk goods between Tasmania and the mainland of Australia, including a comparison with the freight task between regional centres and metropolitan centres on the mainland and related costs.

    b. Quantify any comparative freight cost disadvantage for goods eligible under the TFES and the TWFS, identify its primary causes and assess the impact of that freight cost disadvantage on Tasmanian business in terms of the cost of business inputs and access to markets on the mainland.

    c. Assess the effectiveness of the current scheme arrangements as a mechanism for addressing any freight cost disadvantage, including identification of the costs and benefits, the impact on stakeholders, and any unintended consequences or distortionary effects of the current arrangements.

    d. Identify any alternative mechanisms that could more effectively address any freight cost disadvantage, including assessing the full economic costs and benefits of any alternative mechanisms.

6. In undertaking the inquiry, the Commission is to advertise nationally, consult with key interest groups and affected parties, and produce a report.

7. The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report.

CHRIS PEARCE

[received 21 March 2006]

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Abbreviations

ACCC	Australian Competition and Consumer Commission
BTRE	Bureau of Transport and Regional Economics
CIE	Centre for International Economics
DOTARS	Department of Transport and Regional Development
FCL	full container load
LCL	less than full container load
PC	Productivity Commission
TEU	twenty foot equivalent unit container
TFES	Tasmanian Freight Equalisation Scheme
TWFS	Tasmanian Wheat Freight Scheme
TWFSS	Tasmanian Wheat Freight Subsidy Scheme
WTO	World Trade Organization
TFGA/TCCI	Tasmanian Farmers & Graziers Association and the Tasmanian Chamber of Commerce and Industry

OVERVIEW

Key points

- Tasmanian producers rely heavily on shipping to access mainland markets — the cost of shipping a container across Bass Strait can be more than double the cost of road transport for a similar distance on the mainland.
- The operational objective for the TFES is to subsidise individual shippers' sea freight cost disadvantages relative to a road freight equivalent. However, there is no sound underlying economic rationale for the scheme.
  - If a broader objective of regional development is intended, a sea freight subsidy is unlikely to be the most economically efficient way of meeting this.
- The current arrangements do not operate as intended. The different ways of claiming rebates for the same freight task can result in different TFES payments.
  - Part of the land freight cost can be treated as a wharf-to-wharf cost.
  - A higher wharf-to-wharf cost can be reported within an overall door-to-door cost.
- This results in an overestimate of the extent of wharf-to-wharf freight cost disadvantage, payment of higher than appropriate rebates and poor incentives for shippers. These significant problems cannot be eliminated within the current TFES framework.
- As the Government has announced that the scheme is to continue, the Commission has focused on ways to improve its operation.
- For the immediate future, the Commission recommends that TFES payments should continue to be based on the assessed cost disadvantage of individual shipments but should only be payable on the basis of evidence of actual wharf-to-wharf costs. Parameter adjustments for land components should no longer apply. The administration and auditing of the TFES should focus more intensively on the verification of wharf-to-wharf costs, and transparency should be increased.
  - If there is continued evidence of gaming and overcompensation of freight cost disadvantage, a flat rate of assistance should be introduced from July 2010.
- Payment of a single flat rate of subsidy per TEU shipped would have significant advantages in overcoming incentive problems and reducing administrative and compliance costs.
  - As it would significantly change the current distribution of assistance payments, and possibly involve short term adjustment assistance, it is not proposed at this stage.
- The TWFS should pay the same level of assistance per tonne to wheat shipped in containers and in bulk. The level of assistance should be based on the disadvantage of the least cost method of shipping wheat across Bass Strait, plus intermodal costs, less a rail freight equivalent cost. Wheat should no longer be eligible for assistance under the TFES.

Overview

Tasmania is an island State. This simple geographic fact significantly influences, both positively and negatively, many aspects of Tasmanian life and economic activity. Not the least of these is Tasmania's dependence on sea and air for transporting goods to and from the mainland.

For this inquiry, the Commission has been asked to report on the merits and weaknesses of current arrangements for subsidising containerised and bulk shipping between the mainland and Tasmania, and to provide recommendations on an appropriate future approach and/or arrangements.

The inquiry encompasses two schemes:

- the Tasmanian Freight Equalisation Scheme (TFES), which was established in 1976 and last reviewed in 1998 by an ad hoc body, the TFES Review Authority (Nixon 1998); and
- the Tasmanian Wheat Freight Scheme (TWFS), which was established in 2004, replacing an earlier program set up in 1989 as a temporary support measure.

The inquiry is required to consider:

- the characteristics of the freight task between Tasmania and the mainland, including a comparison with that between regional and metropolitan mainland centres;
- the size and causes of any freight cost disadvantage for eligible goods under these schemes, and the impacts on Tasmanian businesses;
- the effectiveness of current arrangements as a mechanism for addressing any freight cost disadvantages; and
- any alternative mechanisms that could more effectively address any freight cost disadvantage.

Governments have provided sea transport assistance in various forms to Bass Strait shipping and shippers for many years. During the 1970s, the Australian Government provided an annual subsidy to the Australian National Line to operate the *Empress of Australia* and currently the Tasmanian Government owns and subsidises the operation of the *Spirit of Tasmania I* and *II*.

In its draft report, the Commission advised that it could find no sound underlying economic rationale for providing freight assistance to particular Tasmanian shippers. Further, modelling commissioned by the Tasmanian Government demonstrated that the schemes benefit Tasmania, but at a small net cost to the Australian community as a whole. Accordingly, the Commission's draft report contained a proposal that the schemes be phased out.

The Prime Minister announced in September 2006 that the TFES is an important element of Australian Government programs that equalise cost disadvantages between the States and Territories and has stated that both schemes will continue to provide freight assistance to Tasmanian shippers. Thus, the Commission has focused this final report on reforms to the current arrangements which would improve their efficiency and effectiveness.

The Tasmanian Freight Equalisation Scheme

The TFES subsidises the shipment of eligible Tasmanian-produced goods to the mainland, and the shipment from the mainland of designated inputs for use in manufacturing, mining, agriculture, forestry and fishing in Tasmania. The subsidy does not apply to the shipment of consumer goods, bulk freight, imports and goods intended for export. Only about 40 per cent of container trade across Bass Strait receives TFES assistance.

Since 1976, over $1 billion has been paid in TFES transport assistance to Tasmanian firms. Expenditure for 2005-06 was $92 million. This is equal to about 0.6 per cent of Tasmania's gross state product and about 0.9 per cent of total production and distribution costs in Tasmania's agriculture, mining and manufacturing sectors.

Freight cost disadvantage — reasons

Because of their reliance on sea freight, Tasmanian producers can be at a freight cost disadvantage when competing in mainland markets. Evidence put to this inquiry demonstrates that the sea freight cost disadvantage is significant. The freight charge for shipping a standard 20 foot container (TEU) across Bass Strait can be more than double the cost of an equivalent road journey on the mainland. The net freight cost disadvantage after the subsidy is in the order of 20 per cent.

Sea freight is inherently more expensive, relative to road freight, over shorter distances such as Bass Strait. Additional sources of sea freight cost disadvantage arise from specialised packaging requirements; intermodal transfers; significant

capital investments required to improve the efficiency of shipping services; and the costs of freight consolidation. Reliance on shipping also requires higher input inventories and the capacity to store additional output. There also needs to be greater investment in transport infrastructure (trailers, containers and the like), given the longer turn-around times.

Shipping costs are adversely affected by cabotage and coastal shipping regulation. In addition, any under-recovery of heavy vehicle road freight costs incurred by mainland producers would widen the relative freight cost disadvantage faced by Tasmania shippers.

The subsidy calculation

The TFES treats as freight cost disadvantage the difference between:

- the costs incurred by shippers for sea freight between northern Tasmanian ports and Victorian ports; and
- the notional freight costs incurred by moving the same type of goods an equivalent distance (approximately 420 kms) on the mainland by road.

For a TEU containing eligible freight which is carried and paid for on a wharf-to-wharf basis across Bass Strait, the calculation of the TFES subsidy is relatively straightforward and transparent. The notional road freight cost is deducted from the invoice cost, a sliding scale is applied to provide some incentive to obtain the cheapest freight rates, and an intermodal transfer allowance of $100 is added.

For most eligible freight tasks, the calculation is more complex and the underlying invoice data are much less transparent. Not all freight is carried across Bass Strait between northern Tasmania and Victoria. Freight which may originate anywhere in Tasmania and be destined for distant parts of any other state may use sea voyages between other ports. Many types of freight are carried and there are different sizes and types of containers. Also, much freight is carried door-to-door (or door-to-wharf or wharf-to-door) by freight forwarders for an agreed total cost, without separating out the individual cost components. Consequently, for subsidy calculation purposes, the TFES uses various fixed-dollar price adjustments and scaling factors to estimate the Bass Strait wharf-to-wharf equivalent component of a particular freight task.

The recipients

Over 1300 shippers benefit from the TFES. In 2005-06, ten claimants received over $2 million each in TFES payments and accounted for over half of the total

assistance paid under the scheme. Included among these were major Tasmanian producers of paper and wood products, frozen vegetables, confectionery and beverages (box). Data provided by a small number of recipients suggest that freight costs as a proportion of total production costs vary widely, from less than 1 per cent to as high as 30 per cent in some cases. The TFES typically meets 62 per cent of Bass Strait equivalent freight costs.

A number of companies claimed that their investment in Tasmania is fragile, and that they would close down some or all of their operations if freight subsidies were not to continue. Others claimed that future investment may shift to other company locations on the mainland or offshore if the subsidies were no longer available. At the same time, these companies have adopted strategies for coping with a wide range of other variations in input costs and market prices, and many are successful exporters.

Some Tasmanian businesses are worse off under the TFES because they compete with subsidised southbound competition. Overall, Tasmania benefits, but at the expense of economic activity in the other states and at a small net cost to the Australian economy.

Box **Major claimants under the TFES, 2005-06**

Claimant	*Major commodity claimed*	*Amount received*
Norske Skog	newsprint	$12.0 million
Simplot Australia	frozen and processed vegetables	$10.9 million
Australian Paper	paper and packaging materials	$6.3 million
Cadbury Schweppes	confectionery	$4.7 million
J Boag & Son Brewing	beverages	$3.6 million
McCain Foods	frozen vegetables	$3.5 million
Cascade Brewery	beverages	$2.7 million
Net Sea Freight	various (*provides freight administration services to multiple clients)*	$2.2 million
Monson Shipping	timber	$2.1 million
Tasmanian Grain Elevators	fodder and wheat *(multiple clients)*	$2.0 million

Source: TFES database.

The Tasmanian Wheat Freight Scheme

Wheat is the only bulk commodity that is eligible for freight assistance to Tasmania. (Like other grains and stockfeed, wheat also receives assistance under the TFES when carried in containers.) No other commodity shipped in bulk, such as petroleum, is subsidised under either scheme. Wheat has represented a very small proportion of total bulk shipments to Tasmania.

Australian Government subsidies for the transport of wheat, predominantly in bulk, were introduced in 1989, in part as a transitional measure to help Tasmanian industry adjust to the changes made to the domestic wheat marketing and pricing regime. It did not end until 2004 when containerised wheat was made eligible under the TFES. However, it was quickly reinstated in a revised form — as the TWFS — later in the same year.

Funding for the TWFS is capped at $1.05 million. It is paid at a flat rate (up to a maximum subsidy rate of $20.65 per tonne), or the shipper's total 'wharf-to-wharf' costs, whichever is the lesser. The uptake of assistance under this scheme has been very small and, despite freight rates for bulk shipping often being cheaper, there were no claims during 2005-06. Participants advised that this is because the net freight cost is lower if wheat is shipped in containers at subsidised rates under the TFES.

Unintended effects of the current arrangements

The design of the TFES and its current parameters provide scope for different ways of structuring rebate claims for the same freight task, resulting in markedly different TFES payments. This has encouraged some shippers to 'shop around' for the most advantageously structured freight bill for TFES subsidy purposes. Opportunities for gaming the scheme exist, reinforcing the view that the arrangements are not operating as intended. Though the extent of the gaming is difficult to ascertain, it is not trivial.

The scheme derives support from the perception that it can reasonably measure cost disadvantage and compensate accordingly. However, various design features are a cause for concern. These include:

- deducting a single land freight cost estimate from actual total freight cost bills to determine a notional wharf-to-wharf cost. This provides an incentive for those with high land freight costs to present door-to-door invoices and receive assistance that, in effect, provides a rebate on part of those land freight costs;

- setting a single road freight equivalent estimate against a variable sea freight cost. This magnifies the degree of under and overcompensation of the subsidy, as many shippers with higher sea freight costs would otherwise have had higher road freight costs; and
- the addition of a single intermodal allowance. This provides an incentive to maximise the value of the intermodal tasks covered by the wharf-to-wharf invoice, to which the intermodal allowance is then added.

Further, the parameters are difficult to estimate, have varied over recent years and some are essentially arbitrary. Annual reviews of parameter estimates have shown them to be far from robust and, indeed, despite there having been six parameter reviews in the last decade — which come at a cost — the original 1996-97 nominal values are still used.

Another concern is that the structure of the sliding scale used to determine final rebates weakens the commercial incentives to seek the lowest freight charges. Use of a median sea freight disadvantage to determine the class cut-offs and the sliding scale results in 92 per cent of TEUs (accounted for by nearly 60 per cent of all claimants) receiving at least 75 per cent of the assessed disadvantage.

Together, the current arrangements result in an overestimate of the extent of wharf-to-wharf freight cost disadvantage, pay higher than appropriate rebates and provide poor incentives to shippers. These significant problems cannot be eliminated within the current TFES framework.

Finally, the operation of the TWFS, in concert with subsidies for containerised wheat now available under the TFES, has significantly distorted the pattern of efficient shipment of wheat to Tasmania.

Underlying rationales for government intervention

An important prerequisite for an evaluation of a program, and of the scope to improve its effectiveness, is a sound underlying rationale. However, in the case of the TFES, there has been longstanding concern about the ambiguity of its underlying objectives. For example, the 1998 report by the TFES Review Authority said that the failure to define clearly the concept of freight disadvantage reduced transparency and led to a range of other problems, such as the absence of a clear rationale ‘for excluding some goods and some sea transport modes from assistance’.

Over the life of the TFES, several possible rationales have been suggested. Broadly, they can be categorised as relating to a perceived need to reduce freight costs or to

promote regional development. However, the configuration of the TFES casts doubt on the validity of these suggested rationales.

Many subsidy recipients argued that TFES payments are an entitlement justified by the higher costs to Tasmanian producers of transporting their products across Bass Strait for delivery to mainland markets. Such a scheme would in principle apply to a broad range of goods transported in both directions. In contrast, the TFES applies only to a limited range of northbound non-bulk products, and an even narrower range of goods shipped to Tasmania.

Moreover, many other regions of Australia incur significant costs to transport goods to markets because of their remoteness or the absence of a rail link or all-weather roads. However, producers in such regions have established there in response to other locational advantages and seldom benefit from explicit government freight subsidies.

Some arguments are couched in terms of Tasmania's lack of a highway link or as compensation for the costs imposed on Tasmania by the Australian Government's coastal shipping, road and rail transport policies. However, these arguments are not compelling.

- If the TFES were viewed as compensation for the lack of a 'land bridge', it would logically subsidise all traffic (including passenger traffic), in both directions.
- And, rather than selectively compensate for the impact of other Government policies, the distortionary effects of those policies should be addressed directly through microeconomic reform initiatives.

More generally, the form of assistance provided by the TFES for Tasmanian industry — a subsidy for one cost component of designated goods entering interstate trade — is inconsistent with programs designed to promote regional development elsewhere in Australia. Such programs are typically targeted at overcoming the disadvantage of a specific industry or region.

From the Commission's perspective, there is no clear underlying rationale for providing freight assistance to particular Tasmanian shippers. As a result, it is difficult to draw meaningful conclusions about the appropriate scope of the scheme. However, as the Government has announced that the scheme will remain, the Commission has taken its current scope as a 'given' and focused on ways to make the arrangements operate more efficiently and effectively.

Alternative future approaches under the TFES

In view of the significant design and operational problems besetting the scheme, the arrangements for delivering freight cost assistance should be changed to improve their efficiency, reduce the adverse incentives they create and limit their unintended effects.

A subsidy based on direct wharf-to-wharf costs

The Commission recommends that, for the next three years, the TFES be based on verifiable evidence of actual wharf-to-wharf costs, or the actual wharf-to-wharf component of the overall transport task, and no longer rely on the calculation of this component by a process of parameter deduction. Together with tighter evidentiary requirements and auditing, this would comprise a worthwhile improvement on current arrangements while not resulting in large changes in the current level of assistance provided to individual shippers.

The required evidence should be an original invoice from a carrier (ship operator) or, in the case of shipments that also involve a land transport component, a bill from a third party agent such as a freight forwarder that is supported by an original invoice from a carrier. The largest claimants under the TFES already ship on a wharf-to-wharf basis and have indicated that they could readily meet such a requirement.

While wharf-to-door and door-to-wharf adjustments would be abolished, the remaining parameters of the current TFES would continue to apply. Accordingly the reforms would not fully remove the current incentive to 'game' invoices and would need to be accompanied by additional measures to strengthen administrative arrangements and to facilitate auditing of the revised scheme.

Over the next three years, the scheme should be monitored by the Department of Transport and Regional Services to determine whether there is evidence of continued gaming and overcompensation of wharf-to-wharf costs. If such problems are found to be ongoing and significant, the Government should then introduce a flat rate of assistance per TEU.

A flat rate of assistance per TEU

Payment of freight subsidies as a single common flat rate per TEU would have significant advantages over current arrangements. It would be a transparent means of addressing the underlying Bass Strait freight cost disadvantage. It would directly

overcome almost all of the adverse incentives that the current parameter-based scheme generates. It would improve the commercial incentives for Tasmanian producers to minimise transport costs. It would reduce compliance and administration costs as it would be simple to claim and administer. The difficulties of obtaining appropriate and accurate data to update the important schemes parameters would be largely avoided. Future reviews would need to focus only on the three core parameters of sea freight cost disadvantage: wharf-to-wharf costs; road freight equivalent costs; and intermodal costs.

Balancing a number of considerations, a rate of $500 per eligible TEU would provide assistance equal to more than half of the wharf-to-wharf freight costs for 72 per cent of all TEUs shipped. This rate is lower than would be obtained by spreading the current total assistance of $92 million across all TEUs as such a rate would overcompensate some large shippers and the current TFES parameters themselves overcompensate some freight costs.

Many current TFES claimants oppose the use of a flat rate because they see the intent of the scheme as addressing each shipper's freight cost disadvantage relative to shippers on the mainland. But the current arrangements themselves provide only approximations of the freight cost disadvantage and have inbuilt incentives to overestimate its magnitude. Moreover, accurate assessment of each shipper's freight cost disadvantage is an unattainable goal.

A flat rate would produce gainers and losers relative to current arrangements. Some large shippers who enjoy low freight rates would gain, while shippers whose products incur relatively high sea freight costs would be required to meet more of those costs than they currently do — even though the current scheme design may be over-compensating them at present.

If a flat rate of assistance per TEU were to be introduced at some stage, there may be a need for assistance to alleviate any social and economic hardship that resulted as producers made the transition. If so, the Australian Government could consider providing up to $10 million a year for three years, to be directed to Tasmanian industries or regions that experience adjustment problems. Such assistance should be designed to facilitate adjustment and supplement currently available regional and labour market programs.

Future directions for the TWFS

In view of the Government's decision to retain the TWFS, the Commission proposes that it should pay the same level of assistance per tonne to wheat shipped in containers and in bulk. Shippers' choices would therefore not be distorted by

subsidies that vary by shipping type. The level of assistance should be based on the least cost method of shipping wheat across the Bass Strait, plus intermodal costs, less a rail freight equivalent cost. Wheat should no longer be eligible for assistance under the TFES.

Findings and recommendations

Chapter 3 Tasmania's freight task and freight cost disadvantages

FINDING 3.1

Compared with freight users on the mainland, Tasmanian shippers face a freight cost disadvantage when conducting interstate trade. However, over the last several decades, the real cost of Bass Strait shipping has fallen significantly relative to road freight costs.

FINDING 3.2

Indirect freight cost disadvantages faced by Tasmanian shippers include the quality and reliability of services, and the impacts of government policies.

Chapter 4 Impact on Tasmania and Australia

FINDING 4.1

Modelling commissioned by the Tasmanian Government suggests that there are output and employment benefits to the Tasmanian economy from the TFES. However:

- *The modelled benefits are likely to be an 'upper estimate'.*
- *There is very little improvement in Tasmanian welfare in per capita terms because of the population growth induced by the extra economic activity generated by the sea freight subsidy.*
- *The benefits to Tasmania come largely at the expense of economic activity elsewhere in Australia and at a small net cost to the Australian economy as a whole.*

Chapter 5 Assessment of scheme design

FINDING 5.1

At the core of the TFES rebate calculation, a single estimate of the road freight equivalent cost is deducted from the varying sea freight costs of producers. However, those who incur higher sea freight costs would be likely to face higher land freight costs. In these circumstances, the underlying disadvantage is

overestimated and a higher rebate is paid — this is a design weakness of the current TFES.

FINDING 5.2

Many TFES recipients expressed concern about the manipulation of subsidy claims through the ability to choose the method of claiming.

- *Use of a fixed $230 per TEU land freight cost deduction to derive a notional wharf-to-wharf cost provides an incentive for those with higher land freight costs to claim on a door-to-door basis.*
- *The design of the scheme also provides an incentive for those who claim on a wharf-to-wharf basis to report and claim the highest possible wharf-to-wharf cost for a given door-to-door invoice.*

Consequently, the extent of wharf-to-wharf freight cost disadvantage is overestimated and results in higher rebates being paid. The scope for this cannot be eliminated within the current design of the TFES.

FINDING 5.3

The majority of route scaling factors, estimated in 1996-97, are higher than the estimates in subsequent parameter reviews. A higher estimate results in a lower TFES rebate.

FINDING 5.4

The intermodal cost allowance provides an incentive for shippers to seek wharf-to-wharf invoices that include as many intermodal services as possible, to which the allowance is then added. This results in a higher TFES rebate.

FINDING 5.5

The design of the class cut-offs (based on the median) and the associated sliding scale for rebate payments provide weaker than normal commercial incentives for cost minimisation for the majority of shipments. The use of the median exacerbates this.

FINDING 5.6

A discount of assistance for high density cargo recognises its higher road freight equivalent cost compared to standard weight cargo. However, the size of that discount may no longer reflect current road transport costs.

FINDING 5.7

If the Bass Strait freight market is not fully competitive, there may be some leakage of the subsidy away from intended beneficiaries to the shipping lines.

FINDING 5.8

The current rules as to which freight is eligible for a rebate result in claims of anomalies in treatment, with ongoing calls for extension of eligibility to other classes of Bass Strait shipments.

FINDING 5.9

Some Bass Strait island shippers face particular freight cost disadvantages that are not fully dealt with in the current TFES design.

FINDING 5.10

Administration of the TFES could be improved by:

- *publishing more comprehensive data that is better aligned with the requirements of external analyses of the scheme;*
- *publicly reporting annual payments made to recipient companies;*
- *reducing compliance costs via electronic lodgment; and*
- *publicly releasing parameter reviews as they are completed.*

FINDING 5.11

The Tasmanian Wheat Freight Scheme singles out the transport of wheat to Tasmania from all other bulk cargoes for subsidisation. The original purpose for such selective treatment — facilitating adjustment in Tasmania to a competitive domestic wheat market — has been fulfilled.

FINDING 5.12

The current interaction between the TFES and the TWFS has distorted the efficient pattern of wheat transport. The TWFS was unused in 2005-06.

Chapter 6 Rationales for the schemes

FINDING 6.1

While the operational objective for the TFES is to alleviate individual shippers' sea freight cost disadvantages relative to a road freight equivalent, there is no sound underlying economic rationale for freight assistance.

FINDING 6.2

If addressing Tasmania's disadvantage as a small regional economy is seen as the appropriate rationale, a more targeted regional development program, rather than freight subsidies, would be a more cost-effective means of delivery.

Chapter 7 Alternatives to current arrangements

RECOMMENDATION 1

The basis for claiming TFES payments should be restructured to minimise the adverse incentives that the current scheme generates.

RECOMMENDATION 2

Assistance under the TFES should only be payable on the basis of evidence of actual wharf-to-wharf costs:

- ***Centrelink should specify the documentary evidence that it will accept as proof of wharf-to-wharf costs. As far as practicable, this should be based on original carrier wharf-to-wharf invoices.***
- ***Parameter adjustments of $230 per TEU for door-to-wharf and wharf-to-door costs would no longer apply. Other parameter adjustments would continue to be used.***

RECOMMENDATION 3

The administration and auditing of the TFES should focus more intensively on the verification of wharf-to-wharf costs:

- ***The systems required to administer the scheme should be updated in the light of the more detailed evidence and data processing needed to verify wharf-to-wharf costs.***
- ***There should be more comprehensive public reporting of information, including the annual payments to recipients.***

RECOMMENDATION 4

DOTARS and the BTRE should revise the methodology for setting and updating the remaining parameters, and review them every three years. In particular, they should review how wharf-to-wharf costs should be defined. The results of parameter reviews should be published.

RECOMMENDATION 5

DOTARS should monitor the operation of the revised scheme to investigate whether there is evidence of ongoing gaming and overcompensation of wharf-to-wharf costs. It should report to Government on this matter during 2009.

The report should also examine:

- ***the effectiveness of administration and audit controls;***
- ***the role of all actual and potential claimants who are not producers and shippers of goods assisted under the TFES; and***
- ***any aspects of the Ministerial Directions judged to be causing difficulty at that time.***

If the Government concludes that gaming and overcompensation of freight cost disadvantage remain significant issues, it should introduce a flat rate of assistance per TEU as per finding 7.1, to operate from 1 July 2010.

FINDING 7.1

Payment of sea freight assistance as a single flat rate of subsidy per TEU shipped would have significant advantages in overcoming incentive problems and reducing administrative and compliance costs.

- *A rate set to $500 per TEU would be appropriate.*
- *The subsidy would be applied on a pro rata basis for other than full TEU loads. No other adjustments would apply.*
- *The nominal level of the subsidy would be reviewed every three years.*
- *Structural adjustment assistance of up to $10 million each year for three years could be considered, if it were found necessary to alleviate any social and economic hardship that arose from the introduction of the flat rate subsidy.*

A flat rate of assistance would involve a significant redistribution of current TFES assistance.

RECOMMENDATION 6

The TWFS should pay the same level of assistance per tonne to wheat shipped in containers and in bulk:

- ***Payments under the TWFS should not be capped.***
- ***Wheat should no longer be eligible for assistance under the TFES.***

The level of assistance should be based on the least cost method of shipping wheat across Bass Strait and a rail freight equivalent cost:

- ***Given the lack of recent data on these measures, the Bass Strait wharf-to-wharf container rate and the TFES road freight equivalent should be used in the interim. As such, for three years, the TWFS should pay assistance of $23.12 per tonne, or the shipper's actual wharf-to-wharf cost, whichever is the lesser.***
- ***In concert with the first three-year parameter and operational review of the TFES, the BTRE should estimate the cost of bulk shipments of wheat and the rail freight equivalent, to update the rate of subsidy from that time.***

1 Introduction and scope of the inquiry

This chapter introduces the Commission's inquiry into the Tasmanian freight subsidy arrangements. It provides a brief background to the development of the current Tasmanian Freight Equalisation Scheme (TFES) and the Tasmanian Wheat Freight Scheme (TWFS). It outlines the scope of the inquiry and the Commission's approach to, and conduct of, the inquiry.

1.1 Background

Governments provide financial assistance in various forms for the transport of goods and accompanied passenger vehicles by sea between Tasmania and mainland Australia. For 2005-06, the Australian Government budgeted $131.5 million for financial support, of which about $92 million has been directed to freight subsidies.

The Tasmanian Freight Equalisation Scheme is intended, among other things, to:

> … provide Tasmanian industries with equal opportunities to compete in mainland markets, recognising that, unlike their mainland counterparts, Tasmanian shippers do not have the option of transporting goods interstate by road or rail. (DOTARS 2006a)

In the case of the Tasmanian Wheat Freight Scheme (TWFS), its stated objective is:

> … [to] assist in alleviating sea freight costs of shipping eligible bulk wheat on Bass Strait so that businesses in Tasmania relying on bulk wheat shipments are not unduly disadvantaged. (DOTARS 2006a)

The locational features of Tasmania and, more broadly, its economic and financial development (including assistance for Tasmanian industries), have been the subject of many inquiries since Federation. Notable in the last three decades have been the Callaghan report on industry and employment in Tasmania (1977), the Curran review of its public sector finances (1992) and the 1997 Nixon report, *Tasmania into the 21st Century*. This ongoing analysis and review essentially reflects long-standing debate about the appropriate role of government in providing assistance, having regard to Tasmania's small size, specific economic and employment opportunities and separation from the mainland.

Some of the broader problems faced by Tasmania are addressed by financial transfers from the Australian Government. In relation to the delivery of government services, each state and territory receives a share of GST revenue based on its population share, adjusted by a relativity factor that reflects its assessed per capita financial needs. This arrangement is intended:

> … to enable States to provide the Australian average level of [government] services if they make the Australian average effort to raise revenue and operate at the average level of efficiency. (CGC 2006, p. xii)

Total Australian Government revenue transfers to Tasmania will amount to $2.1 billion in 2005-06, with GST revenue accounting for 70 per cent of this. A further $51 million is provided to local governments, to be allocated as grants by the state grants commission.

These figures exclude Australian Government assistance to Tasmania for the sea transport of accompanied passenger vehicles and freight. While support for passenger services is of fairly recent origin, freight subsidies in various forms have long been provided to Bass Strait shipping and shippers. For example, during the 1970s, the Australian Government provided an annual subsidy to the Australian National Line to operate the *Empress of Australia*.

Since 1976, freight subsidies have been provided mainly through the Tasmanian Freight Equalisation Scheme (TFES). The parameters of the scheme have changed somewhat following subsequent reviews, and there has been ongoing debate about the appropriate criteria for determining eligibility for, and the level of, freight subsidies. Nevertheless, the TFES has now been in operation for three decades and, to date, it has paid over $1 billion in transport assistance to Tasmanian firms. Its primary focus is on subsidising the shipment of Tasmanian-produced goods to the mainland, but it also subsidises the shipment from the mainland of a range of inputs for use in manufacturing, mining, agriculture, forestry and fishing in Tasmania. Consumer goods, imports, goods intended for export, bulk commodities and the back hauling of some empty containers are not eligible for TFES assistance.

The TWFS provides subsidies for the bulk shipment of wheat to Tasmania — containerised shipments of wheat are eligible for subsidies under the TFES. The TWFS replaced an earlier wheat transport subsidy scheme that had been established in 1989 to provide transitional help to Tasmanian wheat users to adjust to the deregulation of the domestic wheat marketing and pricing arrangements.

Wheat is the only bulk commodity that receives freight assistance to Tasmania. Other production inputs shipped in bulk, such as petroleum or cement and the bulk shipment of other grains, are not eligible for subsidy.

1.2 What has the Commission been asked to do?

The Commission has been asked to report on the merits and weaknesses of the current arrangements for subsidising containerised and bulk shipping between the mainland and Tasmania, and to provide recommendations on an appropriate future approach and/or arrangements.

The inquiry encompasses both the TFES and the TWFS, and is required to cover:

- the freight task between Tasmania and the mainland, including a comparison with that between regional and metropolitan mainland centres;
- the size and causes of any freight cost disadvantage for eligible goods under these schemes, and the impacts on Tasmanian businesses;
- the effectiveness of current arrangements in addressing any freight cost disadvantages; and
- any alternative mechanisms that would better meet the objectives of the current arrangements.

The terms of reference are set out in full at the front of this report.

1.3 How has the Commission approached its task?

The broad approach

The Commission's approach to this inquiry is guided by the terms of reference and its policy guidelines as set out in the *Productivity Commission Act 1998*. Guidelines of particular relevance to this inquiry are the requirements to encourage the development of efficient and internationally competitive Australian industries; to promote regional employment and development; and to improve the productivity and economic performance of the economy. Importantly, the Commission is required to recognise the interests of the community generally. Thus, it must look not only at the interests of Tasmania, but also consider the impacts of policies on the Australian community as a whole.

Ambiguity about the objectives of the TFES has been long-standing. For example, while the recommendations of a major review of the scheme in the mid-1980s by the Inter-State Commission report were adopted by the government of the day, its interpretation of the rationale for the TFES was rejected. According to the 1998 report by the TFES Review Authority (the Nixon Review), this left the scheme 'without a well founded rationale for funding' and therefore without a clear

rationale 'for excluding some goods and some sea transport modes from assistance' (Nixon 1998, pp. 3–4). Such lack of clarity adds to the difficulty of determining whether freight subsidies are warranted and, if so, how they should be structured and applied.

Participants provided considerable comment on this matter and during the course of this inquiry the Prime Minister stated that the TFES 'remains an important element of Australian Government programs that equalise cost disadvantages between the States and Territories' (see below).

The Commission's views on the rationales for freight assistance are presented in chapter 6.

Conduct of the inquiry

Following the receipt of the terms of reference in March 2006, the Commission advertised the inquiry in newspapers, on its website and in a circular, inviting public submissions from interested parties.

Issues paper

An issues paper was released in April 2006. Over subsequent months, the Commission met with producers, shipping companies, government agencies and other interested parties, mainly in Tasmania, and participated in roundtable meetings with interested parties in Hobart, Launceston and King Island (see appendix A).

Prior to the release of the draft report, the Commission had received over 60 written submissions, most from Tasmanian interests. These are listed in appendix A and are available on the inquiry website.

The Commission's draft report

A draft report containing the Commission's preliminary views was released in September 2006. The report examined the various rationales put forward to justify the two schemes but found them all to be problematic. Moreover, modelling commissioned by the Tasmanian Government showed that, while the schemes benefit Tasmania, they come at a cost to all Australians. The draft report argued that the provision of freight assistance reflected an earlier era's approach to industry assistance, put in place at a time when such ad hoc assistance — often in the form of high levels of tariffs, quotas and other forms of industry assistance — was

widespread. It contrasted this with the more recent focus on undertaking economy-wide reforms and allowing subsequent adjustments to work their way through.

The draft report argued that the TFES should be phased out over five years, but that this should be accompanied by additional funding to be directed at alleviating social and economic hardship arising from abolition of the scheme. The report also argued that the TWFS, which was unused in 2005-06, should be abolished.

The draft went on to argue that:

- if assistance to Tasmania were to be justified on regional development grounds, it would likely be better provided in another form; and
- if the Australian Government was to continue to subsidise sea freight for eligible Tasmanian producers, alternative mechanisms would improve efficiency and limit the unintended effects of the current scheme. In particular, the report discussed the possible use of wharf-to-wharf invoices and of a flat rate of assistance, which it proposed be paid at $400 per standard international container.

The Prime Minister's statement of 7 September 2006

On 7 September 2006, the Prime Minister issued a media statement announcing that the Government would not phase out the TFES nor abolish the TWFS. He noted that:

- the TFES remains an important element of Australian Government programs that equalise cost disadvantages between the States and Territories; and
- the Government will continue to review Tasmanian freight subsidy arrangements to ensure they are operating as intended and to the benefit of all Tasmanians.

The full text of the Prime Minister's statement is contained in attachment B.

In light of the Government's decision, as announced by the Prime Minister, the final report has focused on ways to improve the efficiency and effectiveness of current arrangements.

Draft report hearings

Public hearings to discuss the draft report were held in Hobart, Launceston and Melbourne during October 2006. At those hearings, 12 submissions were presented, including one that presented the views of eight of the top recipients of TFES payments (box 2.1 in chapter 2), who together account for nearly half of all TFES

payments. Subsequent to the public hearings, a further 28 submissions were received. A full list of submissions is contained in appendix A.

Structure of the report

An outline of the operation of the two schemes is provided in chapter 2. Chapter 3 examines the freight task facing Tasmania shippers, and provides evidence of the freight cost disadvantages they face, while chapters 4 and 5 report on the impacts of the schemes. Chapter 6 provides the Commission's assessment of the different reasons given for subsidising sea freight costs, while chapter 7 discusses alternative forms of freight assistance.

2 Overview of the schemes

This chapter outlines the operation of the TFES and the TWFS. It summarises Australian Government expenditure on the schemes, the key parameters of each scheme, and the means by which payments to claimants are calculated and provided.

The Australian Government finances and administers three transport subsidy schemes that benefit Tasmania. The TFES provides subsidies that reduce the cost of sea transport for eligible goods shipped between Tasmania and the mainland. A second scheme, the TWFS, provides assistance for bulk wheat shipments to Tasmania. The TFES is by far the larger scheme, with expenditure of $92 million in 2005-06. In comparison, the budget for the TWFS is capped at $1.05 million per annum.

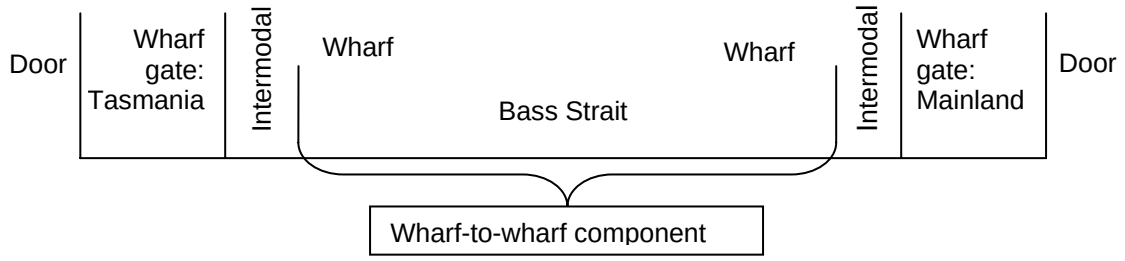
The third scheme, the Bass Strait Passenger Vehicle Equalisation Scheme, is not under reference. It provides subsidies for accompanied passenger vehicles travelling across Bass Strait. Budgeted expenditure for it in 2005-06 was $41 million. The shipping that benefits from this scheme also carries TFES-eligible freight. There are no subsidies for air freight services.

Neither the TFES nor the TWFS are supported by specific legislation. Their operations are guided by Ministerial Directions issued by the Minister for Local Government, Territories and Roads (2002). The schemes are administered by Tasmanian Assistance Services, which is part of Centrelink in Hobart, on behalf of the Department of Transport and Regional Services (DOTARS).

2.1 The Tasmanian Freight Equalisation Scheme

The TFES addresses two elements of sea freight cost disadvantage. One is the difference between the wharf-to-wharf cost of shipping eligible goods across Bass Strait (figure 2.1) and a notional cost of moving the same goods an equivalent distance by road on the mainland. The other is the added cost of the intermodal transfer of goods at each end of the sea journey — commonly, from truck to ship and ship to truck — which is not reflected in wharf-to-wharf freight costs.

Figure 2.1 **Identifying the components of the freight task**



Source: Ministerial Directions for the TFES.

For a standard international container — a twenty foot equivalent unit (TEU) — shipped and paid for on a wharf-to-wharf basis across Bass Strait (for example, from Devonport to Melbourne), the calculation of the TFES rebate is straightforward. A road freight equivalent cost is deducted from the actual wharf-to-wharf cost to give a **notional wharf-to-wharf freight cost disadvantage**. The actual rebate payable is a (decreasing) proportion of the assessed notional wharf-to-wharf freight cost disadvantage (see below). To this, an intermodal allowance is added, to give the total assistance.

For many eligible freight tasks, the calculation is more complicated. Freight may originate anywhere in Tasmania and be destined for distant parts of any other state; many types of freight (including live animals) are carried; and there are different sizes and types of containers. In addition, much freight is carried door-to-door (or door-to-wharf or wharf-to-door) for an agreed total cost, without separating out individual cost components.

Consequently, as detailed in the following sections, price adjustments, scaling factors and calculation formulas are used to estimate the wharf-to-wharf component. Further assumptions are required to arrive at a road freight equivalent cost, a comparison that is made more difficult given that road freight is predominantly weight-based while sea freight is volume-based. Together, these elements of the TFES can generate some unintended consequences, which are discussed in chapter 5. (The TWFS avoids this particular set of difficulties by paying a fixed dollar rate per tonne shipped, with no adjustments — see below.)

A further consideration is that TFES assistance is not available for all goods shipped across Bass Strait. The scheme only covers certain non-bulk Tasmanian-produced goods shipped to the mainland for sale (the ‘northbound’ component), and a restricted range of raw materials, machinery and equipment produced on the mainland for use in Tasmanian manufacturing, mining, agriculture, forestry or

fishing (the 'southbound' component). Assistance is also provided to certain sportspersons and professional entertainers, and for the transport of Tasmanian-based brood mares. Consumer goods, imports, goods intended for export, bulk commodities and the back hauling of some empty containers are not eligible for TFES assistance.

Overall, TFES assistance is available for about 40 per cent of Bass Strait containerised trade.[1] Over three quarters of the subsidies are paid on goods shipped northbound from Tasmania.

Funding of the scheme

Funding for the TFES is not capped. Expenditure is determined by the number and size of claims and totalled $92 million in 2005-06. This is 3 per cent higher than expenditure in 2004-05, but over 10 per cent higher than the $83 million spent in 2003-04, and is over double the subsidy level up until the late 1990s (table 2.1).

Table 2.1 **TFES program expenditure, 1995-96 to 2005-06[a]**

Year	*Northbound*	*Southbound*	*Total*	*Change over previous year*
	$m	$m	$m	%
1995-96	35.0	7.7	42.7	8.1
1996-97	32.1	9.1	41.2	-3.5
1997-98	32.5	8.9	41.4	0.5
1998-99	33.1	8.7	41.8	1.0
1999-00	47.6	11.8	59.4	42.1
2000-01	52.2	14.8	67.0	12.8
2001-02	58.1	13.9	72.0	7.5
2002-03	62.2	15.0	77.2	7.2
2003-04	65.6	17.4	83.0	7.5
2004-05	69.7	19.4	89.1	7.3
2005-06	70.2	21.7	91.9	3.1

a These amounts refer to payments made for claims lodged during a financial year, irrespective of the year of shipment (and hence year of economic incidence). Estimates of expenditure differ according to whether they are compiled on this basis or for claims paid on commodities shipped during a financial year (irrespective of when the rebate is paid).

Sources: Centrelink, *TFES statistics 2005*, report no. 4 and the TFES database.

The large increases in rebates paid in 1999-00 and 2000-01 followed the introduction of a revised scheme in July 1999. At that time, the maximum claim per

1 DIER Tasmania 2006.

TEU was increased by 45 per cent from $590 to $855, and since 1999 over 80 per cent of claimants have received a rebate in excess of $590 per TEU. Other changes, including paying subsidies for newsprint on the same basis as other goods under the scheme, also affected the number and value of claims and, hence, comparisons over time.

Who benefits and to what extent?

The TFES benefited over 1300 claimants in 2005-06.[2] While the average annual payment per claimant in that year was about $68 500, ten claimants received over $2 million each in TFES payments and accounted for over half of the total assistance paid under the scheme. Included among these were the eight major Tasmanian producers of paper and wood products, frozen vegetables, confectionery and beverages (box 2.1). Together, they accounted for over 50 per cent of all TEUs shipped under the TFES.

Box 2.1 **Major claimants under the TFES, 2005-06**

Claimant	*Major commodity claimed*	*Amount received*
Norske Skog	newsprint	$12.0 million
Simplot Australia	frozen and processed vegetables	$10.9 million
Australian Paper	paper and packaging materials	$6.3 million
Cadbury Schweppes	confectionery	$4.7 million
J Boag & Son Brewing	beverages	$3.6 million
McCain Foods	frozen vegetables	$3.5 million
Cascade Brewery	beverages	$2.7 million
Net Sea Freight	various (*provides freight administration services to multiple clients)*	$2.2 million
Monson Shipping	timber	$2.1 million
Tasmanian Grain Elevators	fodder and wheat *(multiple clients)*	$2.0 million

Source: TFES database.

Rebates on goods shipped to Tasmania, mainly raw materials for use in production in Tasmania, total about $21.7 million. Fodder ($2.4 million) is a significant item.

[2] This estimate includes divisions of companies, agents and third party brokers.

In 2004-05, eligibility for southbound TFES subsidies was extended to containerised wheat, with about 27 000 tonnes or 1100 containers of wheat being shipped in that year. Approximately $734 000 was paid in assistance, amounting to an average subsidy of about $28 per tonne (table 2.4). In 2005-06, over 63 000 tonnes of wheat (approximately 2600 containers) were shipped, attracting $1.8 million in assistance, an average of about $29 per tonne. There were no bulk shipments of wheat in 2005-06 and therefore no claims against the TWFS (see below). The interaction between the schemes is discussed in chapter 5.

How are TFES entitlements calculated?

The TFES entitlements are based on the concept that the cost disadvantage to be subsidised is the notional wharf-to-wharf disadvantage, which is the difference between:

- the actual (variable) sea freight costs across Bass Strait between northern Tasmania and Victorian ports; and
- a fixed single road freight equivalent (RFE) cost, which is the notional road freight costs of moving goods an equivalent distance (approximately 420 kms) on the mainland. (Since 1996-97, the scheme has used an allowance for the RFE of $281 per TEU for dry cargo and $309 per refrigerated TEU.)

The amount of the notional TFES entitlement rebated is subject to a sliding scale of payments. Shipments are grouped into four classes, depending on their assessed notional wharf-to-wharf freight cost disadvantage per TEU. Based on an estimated median notional wharf-to-wharf freight cost disadvantage of $671 per standard TEU, claimants receive:

- 100 per cent of the first $335.50 of freight cost disadvantage;
- plus 75 per cent of cost disadvantage from $335.50 to $671;
- plus 50 per cent of cost disadvantage from $671 to $1006.50; and
- no refund for that part of any cost disadvantage that exceeds $1006.50.

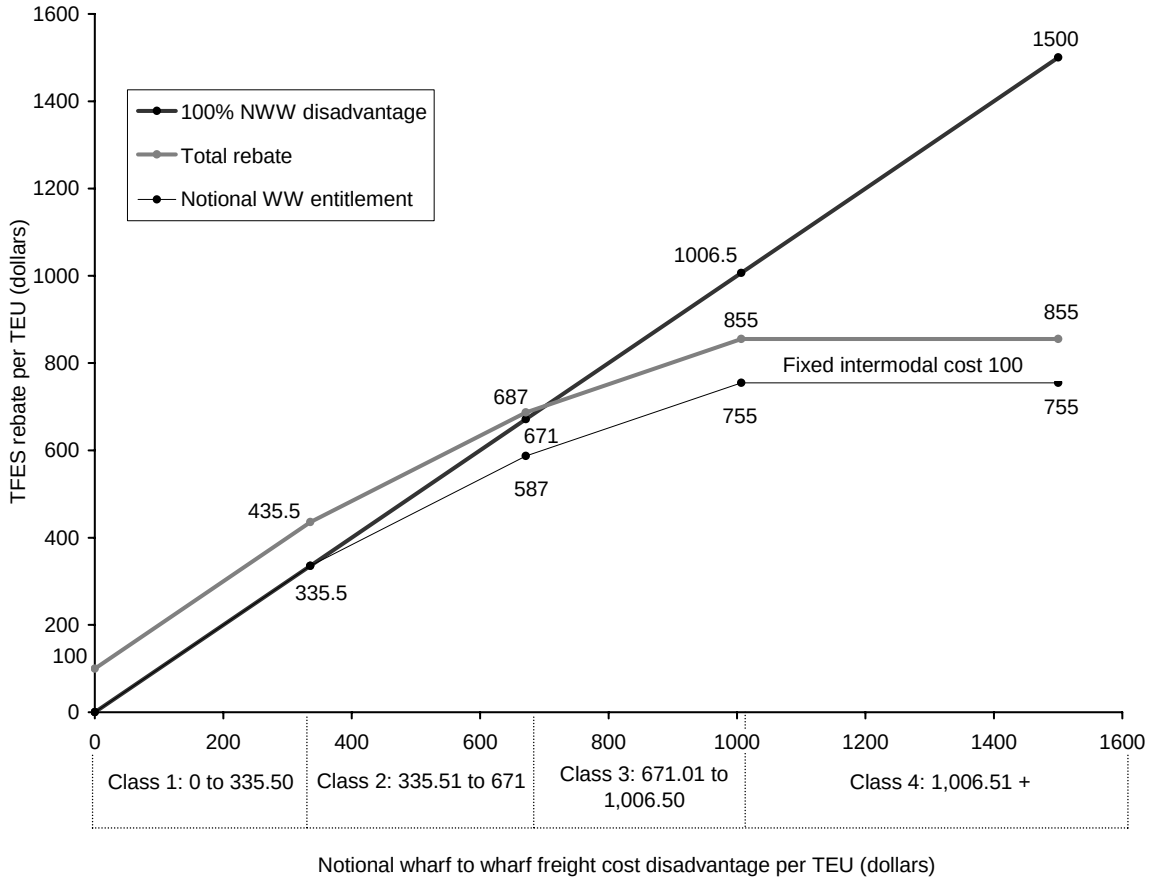
This sets a maximum rebate for the assessed notional wharf-to-wharf freight cost disadvantage of $755 per TEU, to which is added a fixed intermodal cost element of $50 per TEU per transfer, or $100 per TEU per trip, giving a maximum TFES rebate of $855 per TEU.

The result is a sliding scale of TFES rebates payable as the assessed notional wharf-to-wharf freight cost disadvantage, as is shown in figure 2.2.

By way of example, if it costs $900 per TEU to ship a dry container from northern Tasmania to Victoria on a wharf-to-wharf basis, the notional wharf-to-wharf freight cost disadvantage would be assessed at $619 per TEU (that is, $900–$281 RFE). This would classify the shipment as a Class 2 shipment and the TEU rebate payable would be $335.50+(0.75x283.50), that is, $548, for the wharf-to-wharf disadvantage. There would also be a $100 per TEU rebate for the intermodal costs (irrespective of their actual value). The total rebate would be $648 per TEU. This would reduce the net cost of shipping from $900 to $252.

Figure 2.2 **Structure of TFES payments**

Assistance received by notional wharf-to-wharf disadvantage



Source: Based on information contained in the Ministerial Directions.

The sliding scale of payments is intended to provide an incentive to shippers to seek out lower freight rates, and to shipping companies not to raise freight rates to take advantage of the subsidy.

For many eligible cargoes, the rebate is 100 per cent of the assessed disadvantage, and for most it is at least 75 per cent of that assessment (table 2.2).

Table 2.2 **TFES rebates by notional wharf-to-wharf freight cost disadvantage**

Notional wharf-to-wharf disadvantage (NWW)	*TFES entitlement before intermodal cost allowance is added*		*Total TFES rebate including intermodal cost allowance*
	Entitlement based on sliding scale	*Entitlement as a proportion of NWW*	
$	$	%	$
100	100	100	200
200	200	100	300
300	300	100	400
400	384	96	484
500	459	92	559
600	534	89	634
700	602	86	702
800	652	81	752
900	702	78	802
1000	752	75	852
1100	755	69	855

Source: Based on information contained in the Ministerial Directions.

TFES parameters

Eligible shipments made on a wharf-to-wharf basis between northern Tasmania and Victoria are able to be processed in this straightforward manner. As only a minority TFES-eligible claims are made on this basis, adjustments must be made to the majority of freight bills to allow an estimation of the notional TFES entitlement and calculation of TFES rebates.

To achieve this, adjustment are made for:

- shipments on routes other than between northern Tasmania and Victorian ports;
- shipments of less than full container (LCL) loads;
- use of transport units other than a TEU;
- the density of the cargo; and
- freight shipped or paid for other than on a wharf-to-wharf basis.

For each of these parameters, a fixed adjustment factor or a set dollar amount applies (box 2.2).

Box 2.2 **TFES allowances and scaling/adjustment factors**

Routes other than between northern Tasmania and Victoria: Scaling factors are used for freight carried to or from other states, with no adjustments for different locations within a state. For example, all locations in New South Wales have a scaling factor of 1.8 for freight to or from northern Tasmania (1.9 for southern Tasmania), and for Queensland the factors are 2.4 and 2.2, respectively.

Less than full container load: A pro rata formula applies.

Use of transport units other than a TEU: A pro rata formula applies for different sized containers.

Heavy or high density cargo: Assistance for cargo with a stowage factor of 1.1 cubic metres per tonne or less when efficiently packed is set at 60 per cent of the standard rate (including the intermodal cost allowance).

Wharf-to-door and door-to-wharf costs: These are set at $230 each. Thus, either $230 or $460 is deducted from bills that are not submitted on a wharf-to-wharf basis.

Source: Ministerial Directions.

Each parameter can be important in the calculation of rebates. For example:

- while 86 per cent of TFES payments are for freight carried as full container loads, there is considerable LCL traffic to and from Tasmania (commonly, live animals);
- over half of the number of claims, but representing only 21 per cent of the value of TFES payments made, are for routes other than between northern Tasmania and Victorian ports, and therefore subject to a distance scaling adjustment;
- about 30 per cent by value of all TFES payments are for refrigerated cargo; and
- only 15 per cent of the number of claims are for wharf-to-wharf transport, but they account for 57 per cent of the value of TFES rebates paid and 64 per cent of TEUs shipped.

In some cases, these adjustments can lead to apparently problematic outcomes. For example, 85 per cent of all TFES claims include the standard allowance of $230 for the wharf-to-door or door-to-wharf component (or $460 in the case of door-to-door delivery), irrespective of the distance between the port and the pick-up/drop-off point and the actual costs incurred. The incentives this can create are of concern to some participants (chapter 5). An example of a calculated entitlement under the TFES is given in box 2.3.

Box 2.3 **Calculating entitlements under the TFES**

The following hypothetical example illustrates how the TFES converts a door-to-door invoice into a payment to a claimant.

- Assume a freight cost of $1500 to ship a non-refrigerated TEU on a door-to-door basis from northern Tasmania to a destination within New South Wales.
- To obtain the notional wharf-to-wharf freight rate for that route, deduct $460 (the combined door-to-wharf and wharf-to-door costs), which gives $1040.
- Applying a scaling factor (1.8 for NSW) reduces that notional wharf-to-wharf freight rate to an equivalent rate ($578) for the Bass Strait route (defined as 420 kilometres between northern Tasmania and Victoria).
- Deducting a road freight equivalent cost ($281) converts this to a notional wharf-to-wharf freight cost disadvantage of $297 per TEU for the Bass Strait component of the journey.
- In this case, the shipper's entitlement, calculated on the basis of a sliding scale of payments, is the full $297 per TEU. As noted in the text, amounts up to $335.50 per TEU of notional wharf-to-wharf freight cost disadvantage are funded in full. Shippers within this category are described as Class 1 shippers in the Ministerial Directions.
- A fixed intermodal cost element of $100 is added, giving a final payment to the claimant of $397 per TEU.

Source: Based on information contained in the Ministerial Directions.

Precise tailoring of subsidies to the cost disadvantage faced by each shipper for each shipment would require careful and costly calculation. There would also be considerable conceptual and data problems. Instead, the scheme opts for an approximate methodology, with lump sum adjustment amounts and predetermined scaling rates. This represents a compromise between accuracy and administrative simplicity.

Adjustment of the TFES parameters

The methodology used to determine TFES rebates is not uncontroversial, and has been subject to several changes following a major review by the ISC in 1985 and the Nixon Review in 1998. However, the architecture and parameters of the current scheme are essentially those implemented in July 1999, following the Nixon Review, the last significant examination of the scheme.

The TFES provides for an annual review of the key assistance parameters.

In addition, the Ministerial Directions have provision for the parameters to be updated when circumstances have changed materially.

There have been six reviews of parameter values since the 1998 review. These have been undertaken by the Bureau of Transport Economics, the Centre for International Economics and the BTRE. The suggested parameters from each of the first five reviews are given in table 2.3.

Table 2.3 **Estimates of selected TFES parameters, 1996-97 to 2002-03**
Recommended values ($ per TEU)[a]

Parameter	*TFES Review Authority 1996-97*	*BTE 1998-99*	*CIE 1999-00*	*BTRE 2000-01*	*BTRE 2001-02*	*BTRE 2002-03*
Fixed intermodal cost	**100**	99	107	113	113	113
Road freight equivalent cost						
Dry freight	**281**	262	295	315	318	324
Refrigerated freight	**309**	288	325	347	350	357
Door-to-door adjustment						
Door-to-wharf	**230**	301	244	248	250	258
Wharf-to-door	**230**	301	244	248	250	258
Total	**460**	602	488	495	500	516
Median notional wharf-to-wharf freight cost disadvantage						
Dry freight		399	691	498	562	531
Refrigerated freight		373	687	623	779	703
All freight	**671**		687	519	603	610

[a] Reviews were undertaken in the years indicated by the TFES Review Authority, the Bureau of Transport Economics (BTE), the Centre for International Economics (CIE) and the Bureau of Transport and Regional Economics (BTRE). Current parameters are shown in bold type.

Source: BTRE 2002-03 parameters study.

Some of the reviews have proposed considerably different values for various key parameters. For example, the door-to-door adjustment has varied from $602 per TEU proposed by the BTE in 1998-99 to $488 per TEU proposed by the CIE in 1999-00. However, none of the parameter reviews have been implemented. Instead, the 1996-97 values proposed by the Nixon Review (Nixon 1998) have continued to be used. The BTRE is undertaking yet another review of the parameters, based on 2005-06 data, due to be completed by December 2006.

While adjustments to the key parameters would have redistributed assistance among recipients, their impact on overall program expenditure would have been small. For example, the BTRE estimated that the use of its proposed parameters in 2002-03

would have led to a reduction in total spending on the TFES of around $1.3 million, or 2 per cent, in that year. DOTARS noted that 'each of the reviews pointed to significant estimation and data problems that constrained confidence in the findings' (sub. 53, p. 10). It also advised that the small impact on overall program expenditure was the reason for not adjusting the parameters.

2.2 The Tasmanian Wheat Freight Scheme

Wheat shipped to Tasmania is used for milling into flour for human consumption, processing as livestock feed or as a supplementary feed in times of drought. From 1989, all shipments of wheat to Tasmania became eligible for an explicit Australian Government subsidy under the Tasmanian Wheat Freight Subsidy Scheme. The subsidy was intended to provide transitional assistance to Tasmanian wheat users to adjust to the deregulation of domestic wheat marketing and pricing arrangements. (Funding of the subsidy had previously been provided by a wheat industry levy under wheat industry marketing plans.) The subsidy, which was capped at $1.2 million, covered all uses of wheat and forms of shipment — bulk as well as non-bulk. The subsidy scheme ended in June 2004 and non-bulk shipments of wheat became eligible for assistance under the TFES. Subsequently, later in 2004 a revised scheme was introduced for bulk shipments — the TWFS.

The TWFS provides for a subsidy at a flat rate of $20.65 per tonne, or the shipper's total 'wharf-to-wharf' costs, whichever is the lesser. Funding of the TWFS is capped at $1.05 million, implying that about 50 000 tonnes would be eligible for subsidy each year at the maximum rate.

The uptake of assistance under the TWFS has been very small. No claims were made for 2005-06. This is said to be because of the availability of greater assistance for containerised shipments of wheat under the TFES. Other influences may have included the sale of the bulk grain handling facilities in December 2003 and the closure of the government-owned Tasmanian Grain Elevators Board, changes in the price differential between wheat and its closest substitute, barley, and the entry into the Tasmanian market of several smaller mainland agents geared towards containerised grain freight (sub. 53, p. 17).

Data on bulk and containerised shipments of wheat, and of subsidies paid for their carriage, are given in table 2.4. Until 2004-05, the majority of wheat shipments to Tasmania were made by bulk delivery, with the amount varying between 40 000 and 60 000 tonnes. In 2003-04, a year of high demand for wheat in Tasmania as a result of drought, the cap on total subsidy payments reduced the subsidy rate to $16 per tonne, compared to around $22 per tonne in the previous year.

Table 2.4 **Bulk and containerised wheat shipments, 1999-00 to 2004-05**

Tonnages and subsidies paid[a]

	Units	*1999-00*	*2000-01*	*2001-02*	*2002-03*	*2003-04*	*2004-05*	*2005-06*
Bulk wheat								
Shipped	tonnes	41 653	49 071	52 300	49 998	62 774	27 433	0
Subsidy paid	$	956 773	1 116 870	1 021 850	1 079 353	1 017 536	566 482	0
— per tonne	$	22.96	22.76	19.54	21.59	16.33	20.65	na
— as % of cost of shipment	%	78	74	62	68	49	54	na
Containerised wheat[b]								
Shipped	tonnes	10 621	3 652	9 118	5 589	10 695	26 852	63 181
Subsidy paid	$	243 227	83 129	178 150	120 647	182 464	753 754	1 844 226
— per tonne	$	22.96	22.76	19.54	21.59	16.33	28.07	29.19
— as % of cost of shipment	%	48	41	38	48	48	52	49

a Assumes an average of 24 tonnes per container. **b** Covered by the Tasmanian Wheat Freight Subsidy Scheme until 2003-04 and by the TFES in 2004-05 and 2005-06.

Sources: TFES Database; DOTARS, sub. 53, p. 19 and pers. comms.

In 2004-05, the inclusion of containerised shipments of wheat under the TFES saw a substantial growth in this form of shipment and, reflecting the higher cost of this mode of transport, an increase in the rate of transport subsidy paid per tonne of wheat shipped. As noted above, there was no payment made under the TWFS in 2005-06.

3 Tasmania's freight task and freight cost disadvantages

This chapter examines the Tasmanian freight task, including the modes, volume, and cost of shipping. It also explores the extent and causes of any 'sea freight disadvantages' faced by Tasmanian shippers, while noting that the presence of the Bass Strait can have positive impacts on various Tasmanian businesses.

As with other users of freight transport across Australia, Tasmanian producers draw on a variety of freight transport services to meet their needs. They utilise both road and rail in transporting goods to and from ports in Tasmania and on the mainland. They also use air transport for high value and time-sensitive goods. Additionally, in common with mainland producers, Tasmanian producers use sea freight for exporting products and transporting bulk goods.

However, unlike their counterparts on the mainland, Tasmanian producers have a unique reliance on sea freight for the purposes of most interstate trade. Further, the short haul nature of the Bass Strait journey does not exploit the natural advantages of sea transport, thus resulting in high freight rates for goods transported interstate. A stylised cost structure of road and sea freight is outlined in box 3.1.

3.1 The Tasmanian freight task

Section 5(a) of the terms of reference requires the Commission to report on:

> … the characteristics of the freight task for containerised and bulk goods between Tasmania and the mainland of Australia …

The following sections focus on the movement of cargo between Tasmania and mainland Australia by first outlining the nature and extent of the Australian coastal shipping task. The Bass Strait sea freight task is then isolated and its specific features highlighted.

Box 3.1 Stylised cost structures of road and sea freight

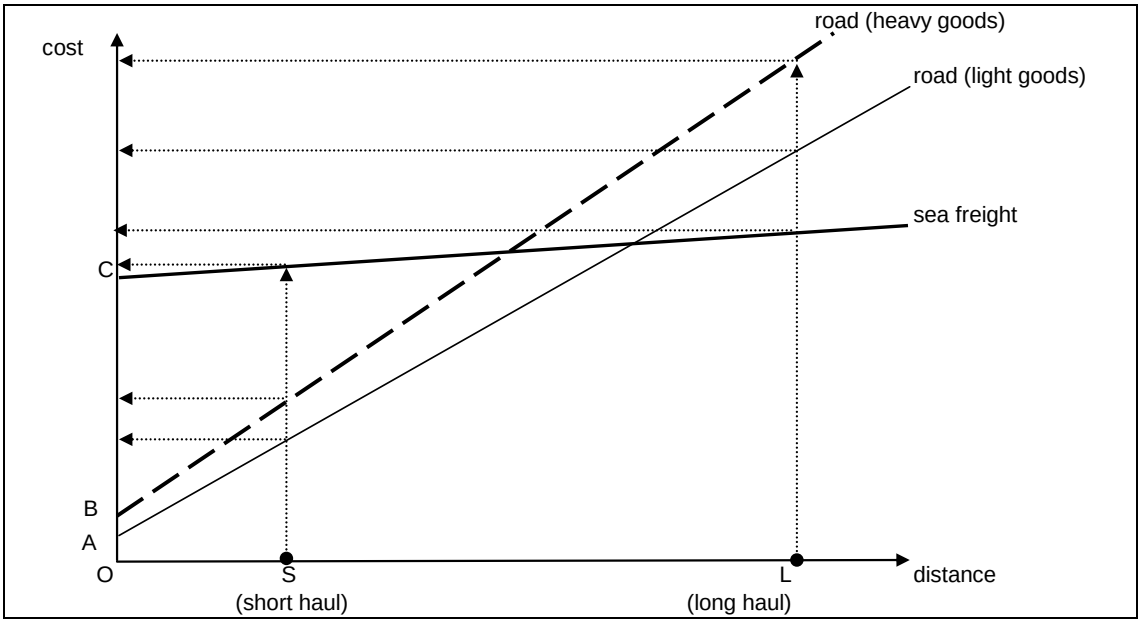
The figure below depicts different cost structures for road and sea freight as they relate to the distance involved in transporting a given volume of goods, such as a TEU.

Sea freight is characterised by large fixed costs (shown as OC on the cost axis) and relatively low marginal costs (represented by the gradient of the sea freight cost curve). The fixed costs include the overhead of owning or leasing vessels, crewing them and the port costs (such as wharfage) associated with loading and unloading the goods. Marginal costs relate to costs that vary with use of vessels over different distances such as fuel, wages and additional repairs and maintenance. For example, the fixed costs of 'getting the ship running' represent roughly 80 per cent of total costs of liner shipping (PC 2005a, p. 281). As such, running a fully laden vessel costs little more than an empty one.

By comparison, road freight has significantly lower fixed costs (OA), representing its relatively low overheads, and a higher degree of flexibility for loading and unloading cargoes. However, this greater flexibility is progressively offset by a steeper marginal cost curve as fuel and crew costs increase at a faster rate with distance. Additionally, as road transport is more weight constrained than sea freight (which is essentially volume constrained), high density cargoes are more costly per unit of capacity to transport by road.

As indicated, road transport is typically cheaper over a short haul (OS on the distance axis), while sea freight is cheaper over a long haul (OL). Rail freight tends to be intermediate between the two.

Freight cost by mode of transport and distance travelled



Australian coastal shipping

Nearly all of the cargo (99.7 per cent by weight in 2000-01) transported across Bass Strait is carried by sea (ABS 9220.0). The most comprehensive data relating to the overall coastal freight task undertaken in Australia are provided by the Bureau of Transport and Regional Economics (BTRE 2006). This indicates that, in 2003-04, coastal freight accounted for over 108 million tonnes, or 15 per cent of all cargo handled in Australian ports.[1] The total level of coastal freight has grown slowly — at an annual average rate of less than one per cent over the previous ten years.

The coastal freight task is dominated by the transport of bulk goods, which made up 87 per cent of all goods loaded and discharged in 2003-04. Bauxite, crude oil, iron ore and petroleum products together comprised 62 per cent of coastal freight loaded in Australia (by tonnage).

The Australian coastal fleet — at 30 June 2004 — consisted of 40 vessels of which 35 were Australian-registered and five were overseas-registered (and licensed in Australia). It comprised:

- 18 bulk carriers (carrying cargoes such as iron ore and bauxite);
- 9 tankers (transporting mainly petroleum products and crude oil); and
- 13 general cargo carriers (engaged mainly in the north Queensland and Tasmanian trades).

This fleet includes vessels that carry cargo and passengers (such as the ships run by TT-Line), but not vessels that carry passengers only.

In addition to the licensed ships, other vessels operate in the coastal trade under the system of single and continuing voyage permits (see box 3.2). The use of permits has generally risen over recent years. As shown in table 3.1, the share of coastal trade carried under permit increased between 1999-00 and 2002-03 by over 15 percentage points on a tonnes loaded basis, before falling slightly in 2003-04. Subsequent data indicate that this share remained constant for the following two years. The increase is more pronounced in terms of tonne kilometres (by some 24 percentage points to one-third of all coastal trade), as permits are more commonly used on longer coastal routes. However, despite the recent increase in the use of permits, most coastal trade is still carried on Australian-licensed vessels.

[1] This measure reflects cargo handled in ports — and thus counts both freight loaded and freight discharged — not the actual freight carried. In the context of coastal shipping (as opposed to international trade), this essentially amounts to 'double counting' of movements of freight, as a given container will be both loaded and discharged in Australian ports. A more indicative figure of the volume of freight is the 53.2 million tonnes loaded in Australian ports in 2003-04.

Table 3.1 **Single voyage permit (SVP) and continuing voyage permit (CVP) activity[a]**

Year	*Coastal trade loaded*	*SVPs and CVPs*	*SVPs/CVPs share of coastal trade*	*Coastal trade*	*SVPs and CVPs*	*SVPs/CVPs share of coastal trade*
	Tonnes (millions)	Tonnes (millions)	%	Tonne kilometres (billions)	Tonne kilometres (billions)	%
1999-00	51.3	3.7	7.2	108.9	9.9	9.1
2000-01	52.0	7.0	13.5	104.5	28.9	28.9
2001-02	52.4	10.3	19.6	110.4	21.4	21.4
2002-03	52.8	12.3	23.3	114.8	37.9	33.0
2003-04	53.2	12.2	22.9	117.5	36.4	31.0

a This table refers to trade carried, not cargo handled. As such, 'coastal trade loaded' has been used as the relevant measure, as discussed above.

Sources: BTRE, *Australian Sea Freight*, Information papers, various; Webb (2004); DOTARS.

Box 3.2 **Licensing of Australian coastal shipping**

In regulating the operation of vessels involved in the Australian coastal trade, the *Navigation Act 1912* gives preference to licensed ships that are subject to two main conditions:

- the seafarers employed on the ship are paid Australian wages; and
- a foreign government is not subsidising the ship.

Licences are not limited to Australian registered, owned or crewed ships. A licence may be issued to a ship operating under any flag, regardless of the nationality of the crew or national ownership, provided that it meets these conditions.

The Act allows non-licensed ships to operate when no licensed ship is available, or the service that the licensed ship provides is inadequate or if it is in the public interest that unlicensed ships be allowed to engage in that trade. In order to operate, a non-licensed ship needs to have either:

- a single voyage permit (SVP) — issued for a single voyage between designated ports for the carriage of a specified cargo; or
- a continuing voyage permit (CVP) — allowing a vessel to carry specified cargo between specified ports for a specified period. Since the introduction of new visa arrangements for foreign crews this has typically been for three months.

Ships operating under permits may be in receipt of a subsidy from a foreign government.

The impact of SVPs and CVPs on coastal trade is shown in table 3.1.

Source: DOTARS 2006c.

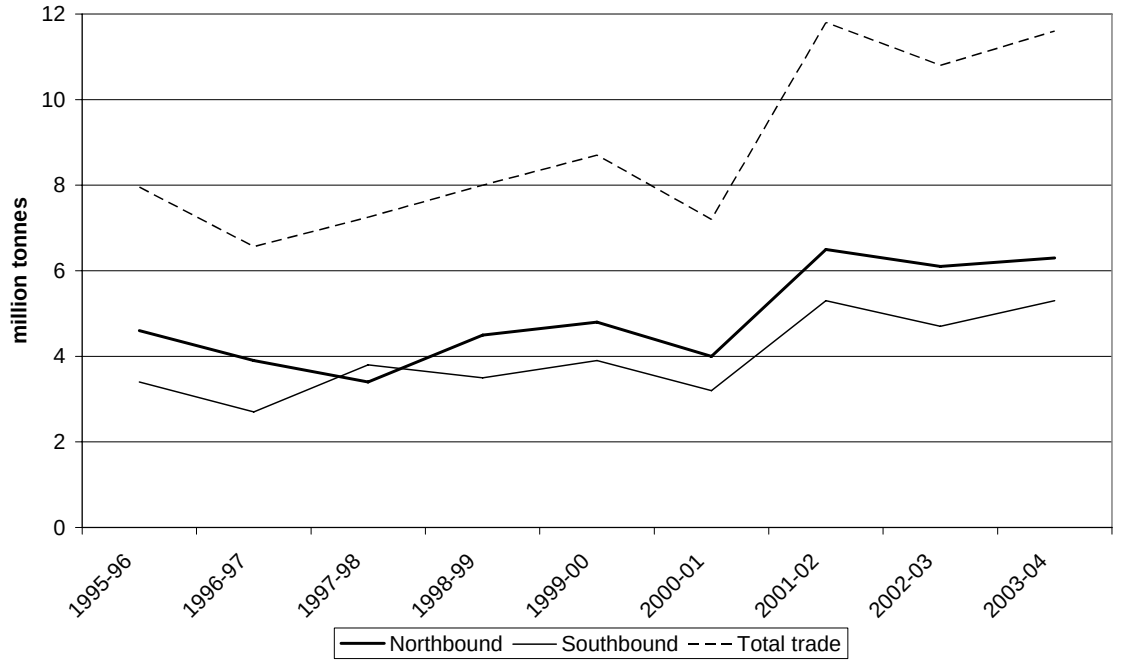
Bass Strait shipping

Tasmanian sea freight accounts for 10 per cent of the total Australian coastal shipping task, and constitutes over 40 per cent of the non-bulk coastal shipping task (BTRE 2006). The importance of non-bulk cargo to the Tasmanian coastal trade reflects the unavailability of road and rail freight options for interstate trade. In 2002-03, of all goods discharged in Tasmanian ports ('southbound goods'), 52 per cent were non-bulk, compared to 11 per cent of goods discharged in all Australian ports. Similarly, 43 per cent of goods loaded in Tasmania ('northbound goods') were non-bulk cargo, compared to 14 per cent for all Australian ports.

Sea freight between Tasmania and the mainland grew by nearly 50 per cent between 1995-96 and 2003-04, to almost 12 million tonnes (figure 3.1). As indicated, annual growth has fluctuated, most notably in 2001 — in response to substantial increases in the transport of two significant commodities traded on Bass Strait, *Metalliferous ores and metal scrap* and *Wood and cork*. Northbound freight makes up slightly more than half of the total tonnage and, in nearly all years, changes in the amount of northbound freight were accompanied by a similar change in southbound freight.

Figure 3.1 **Coastal shipping between Tasmania and the mainland, 1995-96 to 2003-04**

Million tonnes



Source: BTRE Information papers, various.

Currently, eight vessels, operated by five companies (see box 3.3), provide sea freight services across the Bass Strait.

Box 3.3 **Freight carriers across Bass Strait**

Four principal, and one relatively small, shipping operators service Bass Strait. Together they operate eight vessels.

- **Toll Shipping** operates a daily container service between Burnie and Webb Dock Melbourne (*Victorian Reliance, Tasmanian Achiever*). Recently, Toll lengthened both vessels, increasing their capacity by almost 70 per cent.
- **Patrick Shipping** operates a six day a week container service between Devonport and Webb Dock in Melbourne, with one northbound trip per week calling at King Island en route (*Searoad Mersey, Searoad Tamar*). The future of this service will be affected by Toll Holdings' takeover of Patrick Corporation.
- **TT-line** operates two passenger ferries that provide a daily service between Melbourne and Devonport. They have capacity for roll on, roll off freight in addition to their normal passenger/car operations (*Spirit I and Spirit II*).
- **ANL** provides a three day a week lift on, lift off container service between Appleton Dock in Melbourne and Bell Bay, and includes a weekly call at Burnie (*Bass Trader*).
- **Southern Shipping** provides a needs based service from Flinders Island to Victoria. The remainder of the time it services the freight needs of the Furneaux Group of islands, operating a scheduled service from Bridport to Flinders Island, with a once monthly call to Cape Barren Island (*Matthew Flinders*).

Sources: MUA, sub. 59, pp. 4–5; Tasmanian Department of Infrastructure, Energy and Resources 2004.

Composition of sea freight

The major commodities traded between Tasmania and the mainland are listed in table 3.2. In 2003-04, *Metalliferous ores and metal scrap* (mostly copper, iron and tin ores and concentrates) made up over a quarter of the Bass Strait trade, accounting for over 3 million tonnes of freight and were the major commodity traded on both the northbound and southbound routes. Apart from 'special' and 'other' commodities (categories which include unclassified commercial consignments as well as empty containers and packaging), other major commodities shipped to the mainland were *Non-metallic mineral manufactures, n.e.s* and *Paper, paperboard & articles of paper*. Significant quantities of these goods were also shipped south to Tasmania. The other major commodity on the Southbound route was *Petroleum and petroleum products*.

Table 3.2 **Major commodities traded with Tasmania, 2003-04**
Thousand tonnes

Commodity	*Northbound freight*	*Southbound freight*
Metalliferous ores and metal scrap	1 800	1 288
Special transactions and commodities[a]	813	934
Non-metallic mineral manufactures, n.e.s.[b]	1 190	256
Other commodities and transactions[c]	374	887
Petroleum and petroleum products	3	757
Paper, paperboard and articles of paper	694	63
Road vehicles	149	193
Inorganic chemicals	274	10
Cork and wood	218	25
Non-ferrous metals	214	1
Vegetables and fruit	178	31

[a] Includes commercial consignments not classified. [b] n.e.s: not elsewhere stated. [c] includes empty containers and packaging.

Source: BTRE 2006.

3.2 The cost of freight

Section 5(b) of the terms of reference requires, in part, that the Commission:

> Quantify any comparative freight cost disadvantage for goods eligible under the TFES and the TWFS, [and] identify its primary causes …

The following sections examine the cost of freight, both on the Bass Strait and for comparable tasks on land, and then examine elements of Tasmania's interstate freight disadvantage.

The most comprehensive data on freight rates in Australia are those compiled by the Bureau of Transport and Regional Economics. For the purposes of this inquiry, the Commission has also made use of the TFES database.

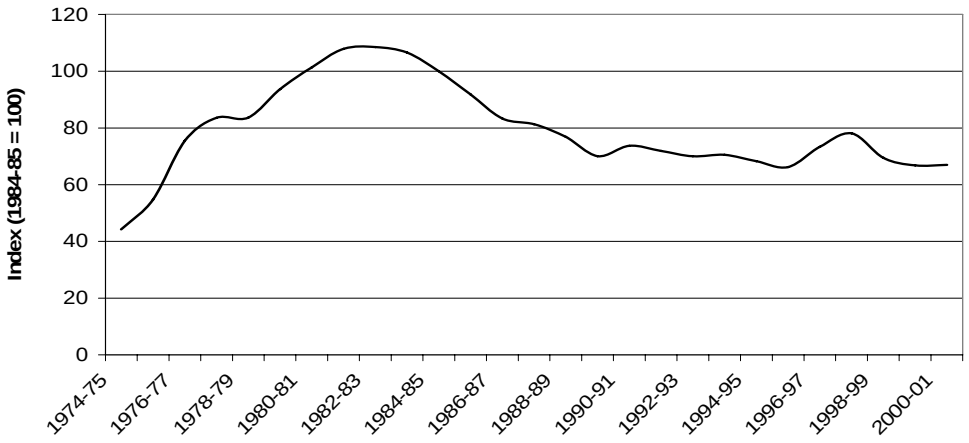
Trends in freight rates

In real terms (that is, adjusted for inflation), freight rates across the Bass Strait increased rapidly in the years following the introduction of the TFES and changes to the arrangements for subsidised shipping services,[2] and peaked in the early 1980s.

[2] ANL (the major carrier at the time) was allowed to increase its rates in July 1976, after a period of almost five years without general rate increases. The ensuing increases saw freight rates rise by

They then steadily declined until 1989-90, and have since fluctuated around a slowly declining trend. Real rates in 2000-01 were still above those in 1975-76, before the TFES was introduced (see figure 3.2).

Figure 3.2 **Real Tasmanian shipping freight rates, 1974-75 to 2000-01**
1984-85 =100



Data source: BTRE 2002.

In terms of transport costs across Australia more generally, there has been a marked and ongoing reduction since the mid-1980s in real sea freight rates between the east coast and Perth, and in rail freight rates Australia-wide (figure 3.3). The reduction in sea rates coincides with the increasing use of single and continuous voyage permits (see above), in particular, international vessels carrying domestic cargo between the south-eastern ports and Western Australia, as part of their international journeys.

In contrast to the reductions in Bass Strait shipping rates, the reduction in road freight rates has been modest. Indeed, between 1984-85 and 2000-01, real road freight rates fell by less than 10 per cent, while real Tasmanian shipping freight rates fell by almost one-third. As a consequence, the difference between the two rates has declined over time, with most of this decline occurring during the 1980s. Some participants argued that, in their experience, this trend has not continued. For example, Norske Skog Paper Mills said that:

> … our experience … is that while Bass Strait shipping costs have reduced in real terms between 1998/99 and 2005/06, road rates have reduced in actual dollars over the same

128 per cent (or 39 per cent in real terms), in response to cost pressures arising, in large part, from an increase in waterside workers' real earnings of 82 per cent (ISC 1985, p. 225).

period due to the introduction of high productivity and purpose built vehicles designed to maximise payloads and back-loading. The relative freight cost disadvantage due to Bass Strait has therefore increased, not decreased between 1998/99 and 2005/06. (sub. DR93, p. 3)

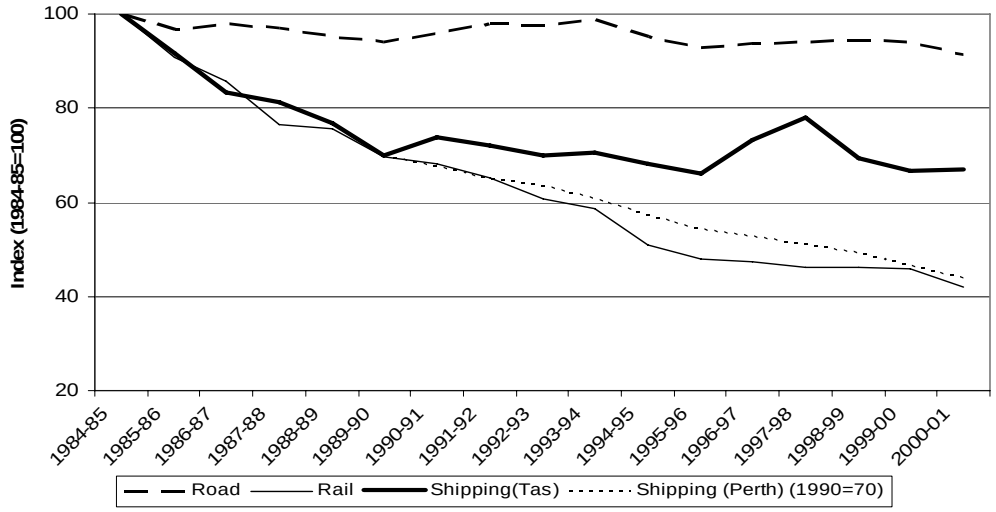
While this may be the experience of particular shippers, subsequent data (ABS 6427.0) indicate that over the same period, in aggregate, the producer price index for road freight has increased by 25 per cent, while the coastal shipping index has fallen slightly (by 1 per cent).

Freight costs for Tasmanian shippers

A measure of the freight costs paid by Tasmanian shippers can be drawn from the TFES database. As outlined in chapter 2, the application of a series of broad parameter estimates has the effect of reducing all freight bills to a common notional wharf-to-wharf cost per TEU for shipping across Bass Strait between northern Tasmania and Victoria. In the first instance, the Commission has filtered out less than full container loads (LCLs). This has the benefit of avoiding excessive variation (see below), without significantly reducing the sample size as compared to the 'raw' database (140 000 TEUs compared to 162 000).

Figure 3.3 **Real freight rates for land and sea based transport, 1984-85 to 2000-01**

1984-85 =100



Data source: BTRE 2002.

This data, summarised in table 3.3, indicate that, in 2005-06, the invoices of 17 per cent of claimants, responsible for 48 per cent of the full containers shipped,

recorded a Bass Strait equivalent cost (after application of the relevant parameters) of less than $800 per TEU. A further 19 per cent of claimants, responsible for a further 24 per cent of the full containers, recorded between $800 and $1000 per TEU. Also, the data indicates that 34 per cent of claimants, responsible for only 5 per cent of full containers, recorded more than $1400 per TEU.

The average (weighted mean) Bass Strait equivalent cost of shipping full containers in 2005-06 was estimated to be $872 per TEU, whereas the estimated cost to the median shipper was $1189 per TEU. The average estimated cost of the most expensive shipper was nearly $2600 per TEU greater than the average of the lowest cost shipper. The standard deviation was $481 per TEU. When less than full container loads are included, there is little change in the average, but substantial increases in the median, range and standard deviation of shipper average costs. For example, the standard deviation more than doubles to $1047 per TEU.

Table 3.3 **Estimated Bass Strait freight rates per TEU, 2005-06**

	All shipments[a]		*Bass Strait shipments*[b]	
Freight rate per TEU	*Proportion of claimants*	*Proportion of TEUs shipped*	*Proportion of claimants*	*Proportion of TEUs shipped*
	%	%	%	%
less than $600	5.7	24.8	9.4	0.8
$600 to $800	11.0	22.9	29.0	58.8
$800 to $1000	19.3	24.1	23.9	6.6
$1000 to $1200	15.4	16.6	13.8	29.6
$1200 to $1400	14.5	7.0	7.2	3.7
$1400 to $1600	10.7	3.2	0.7	0.0
Over $1600	23.3	1.4	15.9	0.4

[a] Based on claims recorded as full container loads, on any route, on any basis and adjusted according to the parameters in the Ministerial Directions. [b] Based on claims recorded as full container loads, across Bass Strait, on a wharf-to-wharf basis.

Source: TFES database.

The scaling factors and set allowances incorporated in the TFES to cater for the different eligible freight tasks, types of packaging and methods of payment, together with the imprecision of the parameter estimates of those factors and allowances all detract from the ability of the TFES database to provide an accurate indication of actual shipping costs across Bass Strait. As detailed in chapter 5, these factors are likely to result in the estimates of shippers average Bass Strait sea freight costs, and the range of such costs, being overstated.

An indication of the 'bias' in the TFES database is provided by focusing the analysis on only those TFES claims that were supported by actual wharf-to-wharf invoices between northern Tasmanian and Victorian ports.

Bass Strait wharf-to-wharf costs

Wharf-to-wharf invoices between northern Tasmania and Victoria were submitted for 65 per cent of all full container loads. Despite this reduction in sample size, this 'Bass Strait sample' is still significant, and representative of a range of trade (encompassing 67 commodities and nearly 140 claimants, who recorded total claims varying from one to over 25 000 TEUs). It represents 87 per cent of all containers recorded on a wharf-to-wharf basis.

Information from the TFES database on this sample, summarised in table 3.3, indicates that 38 per cent of such claimants paid an average of less than $800 per TEU in 2004-05 and shipped 60 per cent of all full TEUs. A further 24 per cent of such claimants paid between $800 per TEU and $1000 per TEU and shipped 7 per cent of all TEUs. Also, the data indicate that 17 per cent of claimants paid more than $1400 per TEU, but shipped less than one per cent of all TEUs.

The average Bass Strait wharf-to-wharf invoice cost for full containers in 2005-06 was $820 per TEU (compared with $872 for the wider sample above), and the cost to the median wharf-to-wharf shipper was $888 per TEU (compared with $1189 above). The range was over $2300 per TEU and standard deviation was $529 per TEU.

As is evident from a comparison of the samples within table 3.3 and the summary statistics referred to above, claims for shipments other than those on a wharf-to-wharf basis between northern Tasmania and Victoria, once adjusted for the various TFES factors and allowances, produce significantly higher estimated sea freight costs. Invoices presented on a Bass Strait wharf-to-wharf basis had an average cost of sea freight between northern Tasmania and Victoria that was over $50 per TEU lower, and the median was reduced by $300 per TEU.

Freight rates by commodity

Given the nature of shipping services (see box 3.1), variation in rates across commodities and routes is to be expected:

> Carriers may charge different rates for different commodities on the same voyage, different rates for similar commodities on different legs of a voyage, and different rates for similar commodities on the same voyage. Typically, higher rates are charged on more valuable cargoes. (PC 2005a, p. 46)

Due to the nature of the transport task involved, goods with specialised transport needs pay higher rates, reflecting the quality of shipping service provided to transport such cargoes. For example, as shown in table 3.4, commodities such as fresh fish ($2050 per TEU) and adult cattle ($1393 per TEU) pay higher rates than commodities with less complex transport requirements, such as wheat ($796 per TEU) or wood and cork ($677 per TEU).

Shippers with medium to large, frequent and fairly uniform shipments pay some of the lower freight rates. As 'anchor' clients they are often in a position to negotiate more favourable rates with carriers. Interrogation of the database indicates that, for shipments of more than 500 TEUs, such claimants can obtain wharf-to-wharf rates in the range of $550 to $650. This aligns with confidential information from one participant, who suggested that regular shippers of even a medium volume of non-specialist products could usually achieve a wharf-to-wharf rate of between $500 and $700 per TEU. Unfortunately, an insufficient number of shippers and shipping companies made their freight rates available on the public record to enable this assessment to be openly verified.

Table 3.4 **Average freight rates by selected commodity, 2005-06**

Commodity	*Average freight rate – all shipments*[a]	*Average freight rate – Bass Strait shipments*[b]
	$ per TEU	$ per TEU
Newsprint and paper	np[c]	np[c]
Vegetables – frozen	953	1 023
Mining and manufacturing raw materials - all other goods (southbound)	829	767
Wood and cork	679	677
Timber	838	871
Vegetables – fresh	1 069	1 286
Metal waste and scrap	1 031	997
Fish, fresh	2 047	2 050
Adult cattle	1 526	1 393
Fodder (southbound)	1 276	1 271
Wheat (southbound)	1 277	796

[a] Based on claims recorded as full container loads, on any route, on any basis and adjusted according to the parameters in the Ministerial Directions. [b] Based on claims recorded as full container loads, across Bass Strait, on a wharf-to-wharf basis. [c] np: not for publication - although this category represents a large volume of shipments, average freight rates are not published due to the limited number of claimants involved.

Source: TFES database.

There is no strict definition in the Ministerial Directions regarding which components of costs should be included in a 'wharf-to-wharf' invoice. Indeed,

based on the Commission's consultations, it is unclear if the rates recorded within the database represent only true 'wharf-to-wharf' costs or include some other components over and above this, or are a mix of both. For this reason, and others detailed in chapter 5, the Commission believes that some of the rates reported to Centrelink may overstate the true cost of shipping on the Bass Strait, and as such may distort the mean (and median) value of claims for commodities, and may generally distort the database as a whole.

Intermodal costs for Tasmanian shippers

Tasmanian shippers incur costs of loading and unloading their cargoes in order to use a combination of sea and land freight. Freight has to change mode at least twice if sent between Tasmania and the mainland, whereas freight between the mainland States and Territories can be transported by only one mode (see box 3.4 — though note that intermodal transfers can also apply to land freight, particularly if rail transport is involved). In addition to such packaging, loading and associated infrastructure costs the Major Tasmanian Manufacturers also noted the effect of 'intermodal dislocation':

> … the additional costs imposed on shippers through the inability to operate a typical line-haul operation over the full length of the door-to-door supply chain. In optimising the supply chain to minimise overall costs for a Bass Strait transit shippers will target maximise stowage rate efficiencies in containers. This often imposes reduced efficiencies on the landside components of the freight task in the form of the need to both transport additional 'dead weight' in the form of containers and the inability to maximise vehicle payloads on the door-to-wharf and wharf-to-door legs. (sub. DR91, p. 2)

The TFES currently provides an allowance of $100 per TEU in recognition of intermodal costs.

Associated with intermodal costs is the higher likelihood of damage to goods. The greater the number of times a good is handled, the greater the chance of damage. As Fruit Growers Tasmania noted:

> Shipping from southern Tasmania to the north and then sea freight across Bass Strait involves a number of handlings. This increases the difficulty in maintaining the fruit in peak condition ready for the market. (sub. 32, p. 4)

Additionally, there is generally a greater risk of damage to goods travelling by sea, a factor often reflected in correspondingly higher insurance premiums, as well as the direct cost of damaged product:

> Due to the number of times that product must be 'handled' on the journey from Hobart to Melbourne, and because part of the journey is by sea over notoriously rough waters,

the amount of product damage incurred is significantly higher on this route than for a similar length trip by road only. (Cadbury Schweppes, sub. DR83, p. 7)

Tasmanian shippers can also face costs arising from the greater use of containers and specialised forms of packaging to cope with the sea voyage. Additionally, an imbalance in trade flows can cause:

> … movement of empty containers back into Tasmania, which adds to the overall shipping cost. Interstate transport costs between mainland states can take advantage of backloading, which is unavailable to Tasmanian manufacturers. (Classic Foods, sub. 28, p. 1)

Box 3.4 **Intermodal transfers from Tasmania to the mainland**

The intermodal transfers required for a journey between Tasmania and the mainland differ from those for a journey solely on the mainland. For example, according to Cascade Brewery, its freight task from Tasmania to the mainland typically involves:

- loading at production site onto taut liners (curtain sided trailers) and road freight to the transport depot in Hobart (Macquarie wharf area);
- containerisation of product at the Hobart transport depot, using slip sheets to replace pallets in order to maximise payload;
- land transport within Tasmania generally via rail or road to the outbound ports of Burnie, Devonport or Bell Bay;
- container handling at outbound port;
- sea freight from Tasmanian to mainland port (usually Melbourne);
- container handling at mainland port;
- rail transport to destination (Sydney, Brisbane, Adelaide and Perth) if not for delivery within Melbourne;
- 'de-stuffing' of container at destination capital, transfer from slip sheet to pallets, and loading onto taut-liner or semi-trailer for delivery; and
- road freight to, and unloading from the taut liner, at the final destination.

In contrast, the freight task for road transport on the mainland would involve the equivalent of the first and last steps of the above process, namely:

- loading at production site onto 'B-double' trailers and road freight to the destination site; and
- unloading from the vehicle at the final destination.

Source: Cascade Brewery, sub. 4, p. 1.

Comparable road freight costs

A third factor required for the calculation of the basic freight disadvantage under the TFES is the cost of a 'comparable' road freight task (see chapter 2 for the calculation of the current 'road freight equivalent').

Evidence provided by a limited number of participants (box 3.5) indicates that Bass Strait shipping costs are as much as two to two and half times greater than road freight costs. Even after receiving the subsidy, there is still a disadvantage, varying generally from 3 to 20 per cent, although some goods face higher disadvantages.

For example, shipping a pallet of apples from the Huon Valley in the south of Tasmania to Melbourne costs approximately 120 per cent more — before TFES payments — than transporting the same shipment between Melbourne and Adelaide (a similar distance). After TFES payments, the sea freight cost is still 40 per cent more (Fruit Growers Tasmania, sub. 32, p. 4). Similarly, the transport of a trailer of cows across Bass Strait which, before TFES assistance, costs $3750 — 118 per cent more than the $1720 cost of transporting the same load between Hay in New South Wales and Melbourne. After TFES payments, the Bass Strait shipment still costs 19 per cent more (Elders Limited, sub. 54, p. 10).

Factors affecting the supply of freight services also cause freight rates to differ. These include the distance to the destination, the timing and availability of the service (for example, the rostering of truck drivers), the proximity of any competition (particularly within road freight and between it and rail freight) and characteristics of both the source and destination themselves (shipments on high volume routes may attract discounts due to economies of scale for the transporters).

The price of transport can vary with the direction of travel. The price for 'backhaul' (freight travelling in the opposite direction to the main trade flow) can differ from, or even being included in, the price on the main trade leg of the journey.

Accordingly, even controlling for the product, distance, direction and timing of a given task, the cost of freight can vary considerably (see box 3.6).

As such, given the variety of factors affecting the price of freight services, it is unrealistic to suggest that any one 'road freight equivalent' is truly representative of a comparable freight task. Indeed, the Nixon Review acknowledged that:

> The difficulties of establishing the road freight costs of a comparable journey to that between Northern Tasmanian ports and Melbourne [are] well documented. … the adoption of a single road freight equivalent rate would be highly controversial. (Nixon 1998, p. 17)

Box 3.5 **Evidence on comparable freight costs**

Several participants provided information on the cost of freight across Bass Strait, as compared to similar tasks on the mainland and elsewhere.

Cascade Brewery commented that:

> Without a subsidy, the cost of freight per km for the Tasmanian sourced product is close to double that of the mainland product. With subsidy, the cost is still notably higher but close enough to the mainland costs to allow us to compete more equitably on other factors … Similarly the freight cost disadvantage for major raw materials used in our operation is reduced to only 25 per cent above costs of our mainland counterpart. (sub. 4, p. 2)

Cadbury Schweppes compared its Hobart to Melbourne and Adelaide to Melbourne routes:

> Without the TFES contribution the Hobart/Melbourne route was 100 per cent more expensive than our Adelaide to Melbourne route … After the TFES contribution the Hobart/Melbourne route was 14 per cent [more] than the Adelaide/Melbourne route … (trans., p. 61)

J Boag & Son reported that:

> Based on current freight rates (and prior to any TFES adjustment) a container costs 229% more to ship from Launceston to Melbourne than it would from an equivalent distance on mainland Australia. (The equivalent comparative distance being Albury to Melbourne). After applying freight equalisation assistance that figure reduces to a cost penalty of 65%. (sub. DR78, p. 2)

Roberts Limited estimated that:

> … road transport of a consignment of lambs across the sea-leg from Devonport to Melbourne would cost between $800-850 whereas the cost to sea-transport the same livestock is $2000. (sub. 19, p. 8)

Classic Foods said that, despite shipping its products:

> ... in the most efficient manner … Bass Strait shipping costs still place us at a 5% to 10% cost disadvantage compared to our mainland competitors. (sub. 28, p. 1)

Norske Skog noted that:

> If there was a land bridge to the mainland, the Boyer Mill could transport paper to its Melbourne customers for 45 per cent less than at present. While TFES payments meet part of this additional cost, they do not fully compensate for the difference. (sub. 24, p. 18)

Net Sea Freight suggested a road freight cost for a journey of 420 kilometres (the equivalent of the Bass Strait) of $336 per TEU:

> Advice from road operators is that, currently, a cost of around $1.60 per km per truck for a two-TEU load … or $0.80 [per km] per TEU … is what the road transport industry uses as an estimated cost … (sub. 26, p. 19)

Additionally, such costs are magnified for shippers from the Bass Strait islands, where, in addition to the cost of shipping fertiliser from Victoria being 'almost double for King Island, than for mainland Tasmania', the King Island Council noted that:

> It is more expensive to ship a full container of Kelp from King Island to Melbourne (over $2000), than from Melbourne to the UK ($1600). (sub. 6, pp. 1–2)

Box 3.6 **Variability of rural freight cost indicators**

Austroads, the association of Australian and New Zealand road transport and traffic authorities, has produced estimates of intra-state rural freight costs as part of its report, *National Performance Indicators 2003*. The rural freight cost indicator — a State by State average per tonne-kilometre — is obtained by a telephone 'shadow shopping' survey of prices for the delivery of 100 tonnes of bricks from the relevant capital city to a rural centre within the state, approximately 400 kms in distance. Several other details of the freight task are also held constant:

- the bricks are to be picked up and delivered during working hours (8am to 5pm);
- loading and unloading will be provided;
- there is no return load;
- the bricks are in packs; and
- there are approximately 33 000 bricks.

The results of the survey for 2002-03 revealed an average charge of 11 cents per tonne/km in four of the participating jurisdictions (Victoria, Queensland, Western Australia and Tasmania), 9 cents in South Australia and 8 cents in the Northern Territory.

There is significant variation in the cost of an apparently identical task within each of the jurisdictions, as the (weighted) average of the standard deviation across the participating jurisdictions was 5 cents, while the range of quotes in each jurisdiction was generally over 20 cents per tonne/km. Together, these indicate that — even for a given freight task — there is considerable variation in the costs underlying these averages both within jurisdictions and between them.

2002-03 was the last year of this survey, as a new indicator is to be developed.

Source: Austroads 2006, personal communications.

Nonetheless, the Authority went on to recommend the adoption of a single rate, noting that the gains from additional precision from differential rates may be outweighed by the extra administrative costs and complexity they would entail. The Commission concurs with this view, while noting the distortion this causes to the assistance paid under the TFES (explored further in chapter 5).

FINDING 3.1

Compared with freight users on the mainland, Tasmanian shippers face a freight cost disadvantage when conducting interstate trade. However, over the last several decades, the real cost of Bass Strait shipping has fallen significantly relative to road freight costs.

3.3 Indirect elements of interstate freight disadvantage

As previous reviews (ISC 1985, Nixon 1998) have noted, the disadvantage experienced by Tasmanian shippers extends beyond the relatively higher prices for equivalent distances. It includes the quality and reliability of service, and the impact of government policies.

The nature of shipping services on the Bass Strait

Quality and reliability of service

The nature of sea freight is such that certain aspects of service — such as speed, flexibility and frequency — are inherently less than those provided by land transport. This represents an indirect cost to Tasmanian shippers.

Given the cost of obtaining urgent deliveries from the mainland by air freight, many participants advised that they maintained greater inventories of supplies. Some also maintained greater stocks of produced goods than their mainland counterparts as they are unable to supply their goods to mainland markets in as timely a fashion:

> … next morning delivery into mainland wholesale markets is the preferred practice for fresh fruit. Whilst this is achievable from regional and metropolitan centres on the mainland, due to shipping schedules across Bass Strait this is impossible from Tasmania. (Fruit Growers Tasmania, sub. 32, p. 4)

> There are also indirect costs such as those caused by the strict 'cut off' times for freight delivered to the ships. If transport is delayed and the cut off time for the ship is missed delivery to Melbourne is delayed 24 hours. This delay invariably means that a delivery to the supermarkets is lost resulting in loss of sales. (Premium Fresh Tasmania, sub. 12, p. 2)

Factors such as the weather and reliance on a limited number of vessels affect reliability of shipping to a greater extent than road transport. (However, wet weather, dirt road closures, track maintenance and other factors have a significant impact for many mainland regional areas.) Businesses located on King and Flinders Islands are particularly affected in terms of reliable shipping services:

> With one service per week to/from King Island, local industry is heavily reliant upon a guaranteed service in order to freight goods on and off the island. On average, a service does not occur because of scheduled maintenance, machinery breakdown or the vessel cannot enter the wharf on average twice a year due to weather conditions. A number of local industries (such as King Island Dairy) must maintain a risk inventory of 2-3 weeks on hand in case of poor weather. When the vessel does not arrive, it is yet another cost disadvantage with which King Island industry is faced. Businesses also

have to make emergency arrangements to export products with short term perishable lives into the market place using expensive air freight. (sub. 6, p. 3)

Less efficient practices

Some participants said that the structure of the schemes can reduce incentives to pursue efficient freight transport arrangements, which results in increased shipping costs (before TFES payments are taken into account) for Tasmanian shippers:

> The current practice of allowing claims on a door to door basis can in effect subsidise inefficient supply chain configurations between the wharf and depot, both on the mainland and in Tasmania … [as] the inefficient supplier can display the lowest net cost to buyer. (Kelly & Sons, sub. 30, pp. 7–8)

The impact of the schemes on the behaviour of shippers is examined further in chapter 5.

The impact of government policies

The 'four ports' system

Tasmania has four principal ports — Burnie, Bell Bay, Devonport and Hobart. In 1996-97, the Tasmanian ports system underwent significant reform, whereby they were established as public corporations under company law and charged with facilitating trade, while operating in accordance with sound commercial practice. The reforms were intended to promote competition between them and improve the efficiency of port services. However, some participants see this as duplication of infrastructure. Net Sea Freight stated:

> At present Tasmania has four major ports — it is likely that none of these is operated at anywhere near their possible capacity on a continuing basis, so that for much of their lives, port assets are idle. An implication of this is that, with permanent dock-side labour, charges for on-wharf activity are likely to be higher per unit (say tonne) shipped. Seasonal highs and lows in shipping, though not as pronounced as in past decades, still exacerbate costs of shippers. (sub. 26, p. 11)

The Tasmanian Government announced the amalgamation of these ports under one body called Tasmanian Ports Corporation (Tasports) in June 2005 — although they would continue to operate as four working ports, their various elements will be run as business units within the one organisation. Tasports is based in Devonport and began operations in January 2006. Capacity rationalisation is one of the issues that Tasports will need to address.

Coastal shipping policies

Although coastal shipping policies impact on the cost of services (through higher crew costs, less flexibility and less competition), reforms undertaken since the mid 1980s (see box 3.7) have resulted in some improvements in this area. Despite this, several participants raised coastal shipping policies as a driver of cost disadvantage on Bass Strait. For example, Australian Paper considered that:

> … the policies of successive Federal Governments have continued to entrench practices that impose a disproportionate cost on the transport of goods across Bass Strait when compared with similar movements on the mainland. These include … Perpetuating high operating cost structures in Australian coastal shipping … (sub. 34, pp. 2–3)

Veolia similarly noted that cabotage:

> … protects the Australian shipping industry but may be responsible for the high cost of shipping from Tasmania and increases in the amount of assistance paid under the TFES. (sub. 21, p. 3)

However, a review of cabotage is clearly beyond the scope of this inquiry. As the Maritime Union of Australia observed:

> … this review, focussing only on Tasmanian transport arrangements, is not the appropriate place to examine Australia's cabotage laws. (sub. 59, p. 7)

Kelly and Sons suggested there was an additional effect of such restrictions in relation to the bulk shipping of grain, where the use of permits does not improve the availability of services:

- There is only 1 Australian flag operator of appropriate vessels. Combined with cabotage restrictions, there is clearly a monopoly aspect to bulk shipping; and,
- Single voyage permits provide very limited relief, due to the small and specialised vessel configuration and the unpredictable availability of foreign flag vessels of the required configuration. (sub. 30, p. 5)

Other participants considered that competition from foreign vessels was unlikely to bring down the cost of most Bass Strait trade:

> Structural reform of Australia's coastal shipping operations has been proposed on a number of occasions and it is observed that cabotage policies have been eased. However, overseas vessels operating on Australian coastal routes do not provide the type, frequency and scale of service required by most Bass Strait shippers. (TFGA/TCCI, sub. 35, p. 9)

The Commission's views on this matter are discussed in chapter 6.

Box 3.7 **Reform of coastal shipping**

Under previous policies, the *Customs (Prohibited Imports) Regulations 1956* (Cwlth) prevented the importation and use of vessels (unless written ministerial permission was obtained) as part of a policy to encourage local shipbuilding. This meant that shippers (on the Bass Strait and elsewhere in Australia) were restricted from accessing relatively cheap second hand ships in good condition which became available on the world market from time to time (ISC 1985, p. 70). These restrictions no longer apply.

Other reforms to the coastal shipping industry since the mid 1980s have included:

- reductions in crew levels (a halving of average crew levels since the early 80s, now approaching international levels) and the introduction of multiskilling;
- the replacement of industry with company employment;
- the use of single and continuing voyage permits (see text);
- privatisation of the Australian National Line; and
- the removal of support measures for ship purchases.

Source: Webb 2004.

Cost recovery policies for road and rail transport

There is a perception that both road and rail transport users are effectively subsidised through the under-recovery of costs for some road and rail infrastructure, and that this in turn makes shipping relatively more expensive, increasing any disadvantage faced by shippers. The Maritime Union of Australia argued that:

> … the full costs, including externalities, should be taken into account in determining a transparent and full cost freight pricing framework for transport. … [this would] mean that road and rail transport costs would need to have additional factors included, which would further alter the freight cost relativities of road and rail with shipping. We do not believe the application of a full costs approach would increase shipping costs. The net result of a full costs freight pricing model for all transport modes would mean that shipping would be relatively cheaper and therefore the cost disadvantage incurred by Tasmanian producers/shippers would be less. (sub. 59, p. 8)

The Commission is currently undertaking a review of the economic costs of freight infrastructure and efficient approaches to transport pricing, at the request of the Council of Australian Governments (see box 3.8). Among other things, that inquiry will examine measures to facilitate efficient pricing of road and rail freight infrastructure.

Box 3.8 **Road and rail freight infrastructure pricing**

Road pricing

Freight shippers are charged for the use of road infrastructure through fixed (registration fees for the trailers involved) and variable (a diesel excise of 20 cents per litre) components. While technological constraints have (to date) prevented charging on the basis of route taken, mass or distance carried (all of which could provide better indicators of the true cost of the carriage of the freight), these charges do vary by vehicle type. Further, road user charges may not account for the 'external' effects of road freight, such as noise and air pollution, accidents and traffic congestion. However, many of these are addressed to some degree through other mechanisms, including insurance and environmental or safety standards. In addition, road-related environmental externalities mainly occur in urban areas (where road complements sea freight), rather than on major interstate corridors (where the two modes are more likely to compete).

Rail pricing

Similarly, rail freight pays fixed (flagfall charge per train) and variable (charges per gross tonne-km) fees. These charges vary by type of train, as well as the specific route that the freight is travelling. Although there are some external effects of rail freight (eg, accident costs) that may not be fully accounted for in freight prices, negative external effects are generally estimated to be relatively small.

Source: PC 2006.

Offsetting benefits

While there are costs which Tasmanian shippers face that their counterparts on the mainland do not, Tasmania's status as an island is not without its benefits, as Cascade Brewery noted:

> Our Tasmanian identity is also critical to the brand proposition of many of our products, such as 'Apple Isle' Sparkling Apple Juice and Mercury Cider. (sub. DR69, p. 1)

Firms based in Tasmania have a freight cost advantage over mainland firms in supplying the Tasmanian market, both for consumer goods and for inputs for other Tasmanian businesses. In effect, the Bass Strait acts as 'natural protection' for Tasmanian firms operating in their own market. Indeed, in past reviews, submissions have been made by Tasmanian businesses seeking to *prevent* the goods they trade in from being made eligible for southbound assistance under the TFES. For example, in the Inter-State Commission's 1985 report, the Electrolytic Zinc

Company of Australasia (a Tasmanian producer of fertiliser) argued against the inclusion of fertiliser within the southbound scheme:

> … we sell our fertilisers at prices comparable with and, in some cases, less than the larger volume States, but would be unable to do so if we lost a significant proportion of our local market to interstate manufacturers. Loss of viability could ultimately lead to the loss of this local production facility, which is of importance to the local rural industry, and the loss of jobs for Tasmanians. (ISC 1985, p. 329)

In the context of the freight task, the availability of cheaper land relatively close to ports also represents an advantage for Tasmanian firms, compared to some mainland competitors. At the broader level, many Tasmanian firms are able to exploit the island's natural advantages to produce quality products that compete in mainland and world markets.

FINDING 3.2

Indirect freight cost disadvantages faced by Tasmanian shippers include the quality and reliability of services, and the impacts of government policies.

4 Impact on Tasmania and Australia

This chapter evaluates the impact of the TFES on Tasmanian businesses, the Tasmanian economy and on Australia overall. TFES payments equal about 0.6 per cent of Tasmanian gross state product and about 2.3 per cent of value added for the sectors which receive the assistance (agriculture, mining and manufacturing). The importance of TFES payments varies widely between firms and commodities, depending on how significant sea freight costs are in overall production and distribution costs.

While many Tasmanian businesses benefit from the TFES, some are disadvantaged because they compete with subsidised goods from the mainland. The benefit to Tasmania comes largely at the expense of activity elsewhere in Australia and at a net cost to Australia overall.

This chapter evaluates the impact of the TFES on Tasmanian businesses, the Tasmanian economy and on Australia overall.

Section 4.1 examines the importance of TFES payments to businesses. While many participants said there would be significant adverse impacts should subsidies be withdrawn, few provided 'hard data' showing the proportion of total costs and profits represented by TFES payments. In arguing for continued funding of sea freight costs, participants emphasised that: the TFES has been part of the Tasmanian commercial environment for three decades and businesses have been built around its existence; it provides financial support for production activities that are otherwise 'fragile' in respect of their location in Tasmania; and its continued availability is one of a number of financial considerations that might dictate whether some firms or plants might close, or investment might be directed to locations outside of Tasmania.

To supplement the fragmentary firm level data made available to support claims by participants, the Commission examined TFES payments at the commodity/industry level (section 4.2). TFES payments are equivalent to about 0.9 per cent of total industry costs for the agriculture, mining and manufacturing sectors — those eligible for the TFES.

Section 4.3 presents quantitative estimates of the overall benefit of TFES payments to Tasmania. A significant point to emerge is that more than half the gain comes

from expansion of the service sector. The benefit to Tasmania comes largely at the expense of the rest of Australia and at a net cost overall.

4.1 Impacts on Tasmanian businesses

The immediate benefit of the TFES is to lower the (net) costs of sea freight transport for the inputs and outputs of certain Tasmanian businesses.[1] The significance of this for a firm's output, employment, business profitability and investment, depends upon the relative importance of sea freight costs and TFES payments in overall production and distribution costs.

TFES as a proportion of total costs and profits

Paragraph 5(b) of the terms of reference require, in part, that the Commission '… assess the impact of the freight cost disadvantage on Tasmanian business in terms of the cost of business inputs …'.

The following participants provided public information about the proportion of total costs or profits represented by TFES payments, or more generally the proportion represented by freight costs (before some reimbursement of the TFES):

- Cascade Brewery (sub. 4) advised that freight costs comprise approximately 5 per cent of the total cost of its goods.
- In contrast, Premium Fresh Tasmania (sub. 12) advised that interstate freight costs represent approximately 35 per cent of all costs.
- Tasmanian Farmers and Graziers Association and Tasmanian Chamber of Commerce and Industry (sub. 35, appendix, p. 21) estimated that, if TFES assistance paid to vegetable processors was removed and grower prices reduced accordingly, then farm prices for the predominant crop, potatoes, would fall by 13 per cent.[2]
- Classic Foods (sub. 28) said that distribution costs represent about 10 per cent of turnover and that the subsidy reduces its distribution costs by approximately one-third.

[1] The possibility that net freight costs may not be reduced by the full amount of the subsidy is discussed in section 5.7.

[2] This is the weighted average for fresh and processed potatoes. Potatoes represent about 68 per cent of Tasmanian vegetable tonnage and about 51 per cent of packed and processed value. Estimates of price falls for the next largest crops, onions and carrots, were 11 and 38 per cent, respectively.

- Tasmanian Pork Alliance (sub. 45) estimated that TFES assistance represents 3.6 per cent of the average value of a pig.
- Net Sea Freight (sub. 26, p. A2) gave the example of a saw mill that received TFES assistance some 3.3 times its reported profit.
- Veolia Environmental Services (sub. 21, pp. 2–3) reported that the earnings before interest and tax for its Resource Recovery Division in 2005 was about 30 per cent less than the assistance received from TFES.

Value to Tasmanian businesses

The overall output and employment consequences for Tasmania, were the TFES to be abolished, would largely be determined by the circumstances of the major recipients of TFES payments. The Tasmanian Government surveyed this group in 2000 and concluded:

> … the continued provision of TFES for 20 major recipients alone is providing employment for around 4,300 people. The major shippers in receipt of TFES continue to invest large sums in the continued viability of their operations and, on an annual basis, are responsible for a significant proportion of expenditure in the Tasmanian economy. (sub. 52, p. 13)

Many participants emphasised that there would be significant adverse impacts should subsidies be withdrawn. For example, Australian Paper said:

> … TFES assistance is vital to sustaining Australian Paper's Tasmanian mill operations, especially in the current price and demand depressed market. The loss of the company's Tasmanian mill operations would have a conservatively estimated $1.3 billion negative impact on Australia's balance of trade over the next ten years. This would be primarily through the loss of import substitution production (87.5%) but also the loss of exports (12.5%).
>
> Australian Paper's Tasmanian mills, either through direct employment and/or sole customer suppliers, provide employment for 780 people on a full-time basis. The broader employment consequences are conservatively estimated at 2,400 full time jobs.The Australian Government's return is 6.5 times the assistance provided to address the sea freight cost disadvantage incurred in shipping across Bass Strait. (sub. 34, p. 1)

Norske Skog Paper Mills predicted:

> The withdrawal of TFES assistance would significantly impact on the delivered cost of paper to mainland customers. It would also impact on the viability of using recycled fibre from Norske Skog's deinking plant at Albury. (sub. 24, p. 19)

Classic Foods said:

> If the subsidy was withdrawn completely or significantly reduced without a corresponding reduction in Bass Strait shipping costs, there would be a dramatic impact

> on Classic Foods business. Classic Foods would become uncompetitive in some market segments, and the added costs would reduce sales of other products. Between 25% to 50% of Classic Foods current business would probably be lost, with the remainder at risk, with an immediate corresponding impact on the local workforce and economy. (sub. 28, p. 2)

Cascade Brewery stated:

> Any dilution of the scheme's benefits would be detrimental to our business — and the abolition of the scheme would threaten our future. (sub. 4, p. 2)

Simplot said that it operates in a low margin, competitive business where freight costs are significant, and that any reduction in TFES assistance would provide a direct incentive for it 'to source product from the mainland, or more probably, from overseas'. Moreover:

> Simplot suspect there is limited room to pass on the cost impost of reduced TFES subsidies to Tasmanian farmers without a severe (and possibly terminal) effect on supply. Consequently, processing activity within Tasmania may cease as mainland and/or imported product becomes the only sustainable option. … The outcome of this review will influence Simplot's future investment and the degree to which Simplot continue current operations in Tasmania. (sub. DR82, p. 10)

Tasmanian Farmers and Graziers Association and Tasmanian Chamber of Commerce and Industry (sub. 35, p. 11) considered that any downward movement in assistance levels to vegetable processors would be fully passed back to farmers as lower farm gate prices. If so, it estimated a decline in average farm crop income of about $39 000 (about 8 per cent of total cash receipts) (sub. 35, appendix, p. 22). In response, it predicted a substantial reduction in the output of both processed and fresh vegetables, which would threaten the viability of three processing plants and five major fresh vegetable packing operations. It estimated a loss of 1500 jobs, which it claimed was a 'conservative' estimate.

Premium Fresh Tasmania said:

> If Premium Fresh Tasmania did not receive assistance through the TFES to offset the extra costs involved in using sea freight to transport produce to the mainland states the company would have to significantly down size its operations. (sub. 12, p. 2)

National Foods forewarned:

> Any negative change to the current scheme would cause NFL to re-examine alternative mainland manufacturing opportunities and so limit Tasmanian manufacturing sites to only producing those branded products requiring Tasmanian manufacturing origin. This would have significant impacts on the production levels and the longer term viability of our Tasmanian manufacturing plants. This in turn would also have a significant impact on the viability of the Tasmanian dairy industry. (sub. 37, p. 3)

Auspine said:

> Removal of the TFES would render our Tasmanian Business unviable to operate within any mainland State and force a downsizing of operations within Tasmania to align operations with Tasmanian requirements only. (sub. 44, p. 2)

Smaller claimants also said they would be adversely affected by any reductions in assistance:

- Weston Animal Nutrition (sub. 9, p. 1) said that the removal of the subsidy would force it to 'exit this market'.
- Tasmanian Flour Mills (sub. 17, p. 2) estimated five job losses if there were no TFES.
- Tasmanian Feedlot (sub. 43, pp. 2–3) said the southbound TFES it receives for purchases of mainland grain is critical to its ability to successfully export into the Japanese beef market.
- Mader International Pty Ltd (sub. 49) said it is reliant on the subsidy, and it forms an integral component of its business strategy.

Participants' comments on the likely impact on their activities of changing the form of assistance to a flat rate are reported in chapter 7.

Some caution about these predictions

Potentially significant impacts of the TFES at the firm level do not imply similar impacts for the Tasmanian economy overall. TFES payments are equivalent to about 0.9 per cent of total costs and about 2.3 per cent of the value added for the agriculture, mining and manufacturing sectors of the Tasmanian economy (section 4.2). It would be reasonable to expect the overall output and employment effects from withdrawing the TFES to be commensurate.

Adverse impacts arising from a reduction in subsidies also need to be considered in the light of ongoing productivity improvements achieved by businesses and the impact of other developments (favourable as well as adverse) stemming from changes in market conditions. And, while price is always a factor, the competitive position of many Tasmanian products is also due, in part, to some non-price factors.

Some participants provided calculations showing that, even with the TFES, their freight costs are still higher than mainland competitors. Yet their Tasmanian product is competitive — often as a result of specific cost advantages and/or the development and servicing of niche markets or seasonal production.

Some participants provided evidence of how they had continually adjusted to the challenge of ongoing competitive pressures, such as declining world prices, rising real wages, relatively high exchange rates and interest rate rises. For example, Norske Skog said that the real price of newsprint has declined by about 4 per cent a year over the last decade. Confidential evidence was provided by another participant of a rise in unit labour costs by 3 to 4 per cent each year.

Tasmanian Pork Alliance explained how small goods processors had responded to 'low' prices set by Woolworths:

> Centralised purchasing systems operated by Woolworths particularly have resulted in Tasmanian processed products coming under greater competition from mainland product as central purchasing officers set prices which, according to Tasmanian processors, they are unable to match because of higher production and input costs in Tasmania. Improved transport and logistics across Bass Strait have made mainland product more competitive in Tasmanian markets. Smaller specialised smallgoods processors have made strategic decisions not to compete in the price competitive and high volume supermarkets, unless on request from a supermarket. These smaller operations have developed quality and niche markets, both in Tasmania and interstate, where improved freight services have increased access to mainland markets. … Prices have not increased in real terms for over 15 years, forcing producers to continually strive for improved efficiency in feed, capital and labour. (sub. 45, pp. 1, 2)

Some participants identified emerging opportunities not linked to TFES assistance. For example, Fruit Growers Tasmania (sub. 32) noted that Tasmanian cherry production has the potential to treble over the next five years — exported cherries do not receive TFES assistance. The Tasmanian Dairy Industry Strategic Plan for 2006–10 expects a 25 per cent increase in milk production by 2010 and 500 new jobs (Wilson 2006).

Roberts Limited (sub. 19) said recent and continuing re-alignment in the temperate pasture seed market in southern Australia will lead to increased opportunities, particularly in selling palletised pasture seed and early generation cereal seed to mainland re-sellers. Further, with the implications of climate change and tighter inventory issues, Tasmania is being seen as a potential 'drought proof' area for production and multiplication of important seed lines.

How long have individual businesses been receiving TFES?

The significance of the TFES relates not only to its quantum but also to how long a business has been receiving payments. The longer that subsidies are received the greater the likelihood that they become part of the trading environment and incorporated into business plans. The more likely also that there will be cases where marginal businesses are sustained by subsidy payments.

The largest recipients of TFES payments are long standing claimants. At the other end, about half of the active codes in recent years are new or transient and involve very small payments (table 4.1). There were about 1340 active codes in 2005-06. Broadly, 600 new codes were added each year from 2003-04 to 2005-06, and about the same number were not used after having made a claim in a previous year. Most entry (new) and exit codes involve relatively small amounts — the average payments for new codes were $3000 in 2004-05 and $4000 in 2005-06. The respective averages for exits were $3200 and $4900.

Table 4.1 **Entrants to and exits from the TFES, 2003-04 to 2005-06**

	units	*2003-04*	*2004-05*	*2005-06*
New codes	no.	660	574	610
Value of claims	$m	4.2	1.7	2.4
Average value per new code	$	6 397	2 961	4 014
Exit codes (operative previous year)	no.	584	651	570
Value of claims prior year	$m	1.6	2.1	2.8
Average value per code	$	2 791	3 174	4 867

Source: TFES database.

Southbound TFES disadvantages some Tasmanian businesses

Tasmanian businesses that produce inputs used in agriculture, mining and manufacturing face competition from subsidised inputs from the mainland. Cement Australia said that:

> Where TFES allows a Tasmanian producer to replace an equivalent Tasmanian component with a cheaper mainland component a negative effect on the Tasmanian economy could ensue through lost production and lost wages, state taxes, and retained profits. If, however, lower component prices have a significant effect on the finished product's price … this may generate offsetting higher production to meet increased exports to the mainland or internationally. Where the producer does not export, or does not increase exports, the southbound subsidy would lead to a net fall in Tasmanian output and thereby detract from the regional development aims of TFES. (sub. 23, pp. 1–2)

Roberts Limited pointed to Victorian stock-feed manufacturers, which can process overseas imported product and sell it to Tasmanian farmers at prices which reflect southbound assistance. In contrast, Tasmanian stock-feed manufacturers cannot claim southbound subsidies for the same imported ingredients when shipped from Victoria (as they have not gone through a manufacturing stage on the mainland after import). Roberts Limited summed up the situation as follows:

> This creates an unfair advantage for interstate processors who are able to freight cheaper products into Tasmania. Some products are only able to be sourced from overseas – and the processing sector in Tasmania should not be disadvantaged by interstate processors who can work within the regulations to unfairly attract assistance when the scheme itself aims to ensure Tasmania maintains a viable manufacturing industry base. (sub. 19, p. 6)

A somewhat similar situation arises for Tasmanian retailers of inputs from the mainland. Monds and Affleck (a stock feed retailer) noted it cannot claim for the shipping of legumes from Victoria for retail sale to farmers, but if the same Tasmanian farmer buys the legumes from the same Victorian supplier, the farmer gets southbound assistance.

Other examples raised with the Commission, outside of submissions, were: Tasmanian cattle producers and feed-lotters which face competition from subsidised cattle from Victoria in supplying Tasmanian abattoirs; and Tasmanian fertiliser interests facing south bound competition in supplying King Island.

4.2 TFES assistance by commodity

The previous section outlined the limited information available about the significance of the TFES for individual businesses. A more comprehensive and consistent approach to analysing the significance of the payments is to use ABS data to examine TFES payments as a proportion of industry costs and gross state product (GSP).

For the Tasmanian economy as a whole, the TFES payments of about $90 million a year equal some 0.6 per cent of Tasmanian GSP. TFES payments are also equal to about 0.9 per cent of total costs and 2.3 per cent of value added for the industries that produce eligible commodities (table 4.2).

Northbound TFES payments cover about 0.7 per cent of total costs and southbound TFES payments about 0.2 per cent. On a value added basis, TFES payments are about 2.3 per cent.

The TFES payments provide a range of levels of assistance to Tasmanian industries. The two industries that benefit most are *Paper and paper products,* for which TFES payments represents about 4.3 per cent of industry costs, and *Food*, for which TFES payments constitute about 2.1 per cent of industry costs.

At the other end of the spectrum, TFES payments represent a negligible proportion of costs of some manufacturing industry groupings.

Table 4.2 **TFES assistance as a proportion of industry costs and value added, 2004-05[a]**

Industry	*Proportion of industry costs*	
	Northbound TFES 2004-05	*Southbound TFES 2004-05[b]*
	%	%
Livestock	0.7	0.4
Crops	1.3	0.2
Forestry	0.0	0.0
Fishing	0.4	0.2
Coal, oil, gas, iron ores	0.0	0.0
Other metal ores	0.1	0.0
Other mining	0.2	0.2
Food	1.8	0.3
Drinks	0.4	0.3
Other manufacturing (incl. furniture)	0.2	< 0.1
Textiles, clothing, footwear	0.1	<0.1
Wood and products	1.2	0.1
Paper and products	3.2	1.1
Printing, publishing, media	< 0.1	0.0
Petroleum and products	< 0.1	0.0
Chemicals	< 0.1	< 0.1
Rubber, plastic and products	< 0.1	< 0.1
Other non-metallic products	0.4	0.0
Cement, lime	0.1	<0.1
Iron, steel	< 0.1	0.0
Basic non-ferrous metal	0.2	< 0.1
Metal product manufacturing	1.1	0.0
Transport equipment	0.5	0.1
Other machinery & equipment & unallocated	0.0	4.0
Total costs (agriculture, mining, manufacturing)[c]	0.7	0.2
Total Tasmanian costs	0.21	0.06
Value added (agriculture, mining and manufacturing)	1.8	0.5
Value added Tasmania	0.45	0.13

a Total costs and value added for 2001-02 were grossed up to 2004-05, in accordance with the increase in Tasmanian GSP. **b** Southbound TFES payments were allocated to industry on the basis of claimant data (not the commodity claimed). **c** Excludes TFES sports and horses scheme.

Source: TFES database.

The relative importance of the northbound and southbound components also differs between industries. At the aggregate level, northbound payments are about 3.5 times more important than southbound payments (about $70 million annually compared with $20 million). However, for the *Drinks* sector the contributions of northbound and southbound payments to total costs are similar (0.4 and 0.3 per cent, respectively). The *Livestock* sector is another for which southbound payments for inputs are relatively important compared with northbound assistance for its final output.

The underlying national average rate of assistance to value added in 2002-03 from tariffs and budgetary measures was around 4 per cent for the Australian agriculture, mining and manufacturing sectors (PC 2003b, table 2.4).[3] Tasmanian industry shares in this overall assistance. The TFES therefore, can be viewed as providing an additional 2 percentage points solely for eligible Tasmanian industries.

4.3 Quantifying the impact

The provision of subsidies under the TFES sets in motion a chain of market adjustments affecting both the prices and quantities of Tasmanian-produced goods and services sold within the state and to the mainland. The Tasmanian Government commissioned the Centre of Policy Studies at Monash University (COPS) to quantify this complex set of interactions using its multi-regional model. The results are summarised below.

Impact on Tasmania

The Tasmanian Government commissioned modelling has estimated that the introduction of the TFES may have increased overall Tasmanian output and employment by about 2 per cent (about $300 million and 4000 jobs).

The TFES industry groups estimated to have expanded the most were: *Wood and paper* ($21.7 million); *Food* ($15.6 million); and *Agriculture* ($9.2 million).

Beyond the direct recipients, the TFES is estimated to have indirectly advantaged other Tasmanian industries. An important finding was that less than half of the estimated output and employment gain occurs in the industries which receive TFES. The majority of the gain to Tasmania is estimated to have come from an expansion

[3] In dollar terms, the measured budgetary and tariff assistance is around $6.5 billion, spread over Australia wide industry. Separate results for each state are not available. The TFES is included in these figures but is a negligible percentage of the total.

of the service sector because of the direct increased demand for goods and services closely linked to TFES recipients (including road, and port operators) and more indirectly through increased demand for goods and services in a larger economy. The modelling includes increased consumption expenditure by the Tasmanian government because revenues rise with the growing economy.

Several participants pointed to the multiplier effects of the production underpinned by TFES subsidies, arguing that the modelled estimate of an additional 4000 jobs in Tasmania underestimated the importance of the scheme to the state economy. They drew attention to the total employment by firms that receive TFES assistance and the economic impact of their spending within the state. For example, Australian Paper said that:

> A sampling of assistance recipients suggests that the direct employment in TFES assisted companies is likely to be in excess of 6,000 with an additional 21,000 plus full-time jobs depending on the operation of these companies. Given this understatement and the globally competitive environment in which many of the employers operate; Australian Paper believes that the estimated employment impacts are grossly understated. (sub. DR71, p. 11)

Similarly, Cascade said that, in addition to its 100 employees and the $15 million which its activities contribute annually to the state's economy:

> ... we buy 100% of the state's blackcurrant crop, and 95% of the state's raspberries [and pay] $6 million in wages and further annual disbursements to councils, utility and transport providers among others. … our business supports many tradesmen, small businesses and community organisations across the state … (sub. DR69, p. 1)

While it is clear that TFES assistance to eligible firms can also have important flow-on benefits for other activities and for the Tasmanian economy generally, the role of economic modelling is to focus on the overall impacts of the TFES on Tasmania and on Australia. In so doing, it is important not to confuse gross and net impacts, otherwise double counting will result.

For example, not every job in a TFES-recipient firm can be attributed to the TFES. To the extent that recipient firms expand production because of TFES assistance, and increase their demand for other goods and services, some additional economic activity may be attributable to the scheme. Such TFES-induced expansion requires additional resources, which need to be bid away from other uses, with consequent changes to their prices. Correspondingly, some other (unsubsidised) economic activities, within Tasmania as well as on the mainland, will contract as their command over resources is reduced. The modelling seeks to take account of all of these adjustments.

Although output and employment are estimated to have increased, Tasmanian welfare (as estimated by real private consumption per capita) shows little improvement. This is because the output and consumption gains are largely offset by the population increase that is stimulated by the increases in the Tasmanian economy.

Impact on the rest of Australia and overall

The TFES has both benefits and costs to mainland businesses and consumers. Those parties which are estimated to be advantaged include some sea freight and port operators based in Victoria and some operators of land transport services between Melbourne and other mainland capital cities which carry Tasmanian origin product. The Victorian Government (sub. 60, p. 15) said 'rail operators are well known to rely heavily on Tasmanian freight flows on the Melbourne-Sydney route'.

Also, some mainland producers of subsidised southbound inputs benefit from access to a larger market. (Though there is the possibility that some mainland producers may have diverted sales from other mainland or export markets.) The bulk of southbound assistance (about $14 million) is for a broad grouping of commodities called 'mining and manufacturing raw materials'. Fodder is the next largest category (about $2.1 million).

Overall, however, mainland producers collectively lose, as the market advantage for Tasmanian competitors from the northbound element of the TFES is greater than the advantage to mainland businesses from the southbound element.

For the Australian economy as a whole, the gains to mainly Tasmanian activity are estimated to come at the expense of activity elsewhere in Australia, and at a small net cost overall.[4] This small negative outcome on an economy-wide basis arises because the TFES subsidy distorts the efficient pattern of resource allocation and also because of the costs of raising the taxation required to fund the scheme.[5]

Several participants criticised the modelling for not taking account of the likely shift offshore, rather than to the mainland, of some jobs and production that would be lost from Tasmanian were the TFES to end. For example, it was argued that imports would replace any loss of Tasmanian paper production that would not be economic

[4] The overall loss is small in percentage terms because the scale of the TFES, at about $90 million, is small compared to Australian GDP of around $900 billion.

[5] While the transfer of funds from one group of Australians to another balances out in an economy-wide economic cost–benefit analysis, the distortionary effect of higher taxation imposes a cost. A typical estimate of this so-called 'marginal social cost' of taxation is 20 cents in the dollar (PC 2003a, p. 6.5).

without the TFES. However, this is a misunderstanding of the model. It does not assume that production lost from Tasmania would be made up by equivalent production on the mainland. Instead, it assumes that labour and capital resources would flow to their next best use according to changes in their relative rates of return, and thus the increase in mainland activity could be in any industry.

In addition to the costs captured by the modelling there are administrative costs to the government, compliance costs to industry and the adoption of less efficient practices because of the adverse incentives created by the scheme design (see chapter 5).[6]

Modelling assumptions and sensitivity

In view of the availability of this analysis, the Commission did not undertake its own modelling, as it would have used the same or similar model and closure, and the same ABS input–output matrix and TFES data as was used in the Tasmanian Government commissioned report, and in the main would have achieved a broadly similar result. However, in its view, the estimated two per cent output and employment expansion for the Tasmanian economy is likely to represent an upper estimate of the positive gains to Tasmania. There are three main factors at play.

First, a key parameter in the modelling is the degree to which mainland purchasers switch towards cheaper Tasmanian goods — in technical terms, the elasticity of substitution. The relevant interstate trade elasticities are difficult to estimate and the modelling used the existing default values often used with this model. The Tasmanian Government commissioned work found that if the degree of substitution is assumed to be lower than the default values (say, as a reflection of the differentiation of Tasmanian produce in terms of high quality and strong brand recognition) then the output and employment benefits of the TFES would be approximately half as large.

Australian Paper argued that the elasticities faced by many major TFES assistance recipients are high, as their products are highly substitutable. Tasmanian products will vary between those that are fairly homogenous and those that are highly differentiated. A more refined use of the model would attempt to tailor each elasticity. Higher elasticities such as is argued by Australian Paper would result in higher gross benefits to Tasmania from the TFES and higher gross costs to mainland Australia, while lower elasticities would give the reverse result. But while

[6] For example: choosing a less efficient transport solution because it offers higher wharf-to-wharf costs and higher TFES payments; weak incentives to seek lower freight rates because of the sliding scale parameters; and possible inefficiencies arising from inappropriate scaling factors.

this is important in estimating the distribution of gross benefits and costs, it does not alter the overall result that these transfers generate a net cost to Australia. (This is also the case for changes to the 'closures' in the modelling.)

Second, the modelling assumes that the Bass Strait shipping market is fully competitive. If, however, shipping firms and freight forwarders have market power, then they could potentially be appropriating a share of the subsidies in the form of higher freight rates (see section 5.7). With almost all Bass Strait shipping services provided by entities based on the mainland, any such appropriation would flow to the mainland and dilute the benefits to Tasmania of the support provided. Chapter 5 examines this leakage issue, and concludes that it should be a consideration in the design of the scheme.

Finally, to the extent that some of the TFES recipients, especially the largest, are wholly or partly owned by mainland or foreign nationals, and that they receive some of the profits from their Tasmanian operation — a likely assumption — then the overall benefit to Tasmania is further diluted.

Based on the above qualifications, the Commission considers that the Tasmanian Government commissioned modelling provides a broad indication of the type of changes induced by the TFES, but that the estimated output and employment effects are likely to be an 'upper estimate'. Moreover, the emphasis on the Tasmanian gross output (and employment) estimates runs the risk of overlooking other key results: that Tasmanian per capita welfare is estimated to have hardly improved under the TFES; that some Tasmanian businesses are likely to be worse off because of the southbound scheme; and that there is a small net cost to Australia overall.

FINDING 4.1

Modelling commissioned by the Tasmanian Government suggests that there are output and employment benefits to the Tasmanian economy from the TFES. However:

- *The modelled benefits are likely to be an 'upper estimate'.*
- *There is very little improvement in Tasmanian welfare in per capita terms because of the population growth induced by the extra economic activity generated by the sea freight subsidy.*
- *The benefits to Tasmania come largely at the expense of economic activity elsewhere in Australia and at a small net cost to the Australian economy as a whole.*

5 Assessment of scheme design

This chapter evaluates the TFES and TWFS. The Commission considers that the TFES does not rate well in terms of the principles of good program design, particularly in terms of the: maintenance of efficiency incentives; minimisation of scope for scheme manipulation; 'leakage' of subsidy to unintended beneficiaries; and transparency and simplicity for all classes of participants. Moreover, the view that it is possible to compensate shippers for a notional sea freight cost disadvantage without distortionary consequences is found to be flawed.

Section 5(c) of the terms of reference requires the Commission to:

> Assess the effectiveness of the current scheme arrangements as a mechanism for addressing any freight cost disadvantage, including identification of the costs and benefits, the impact on stakeholders, and any unintended consequences or distortionary effects of the current arrangements.

This chapter examines the features of the two schemes and, in particular, whether they give rise to anomalies or unintended consequences.

In particular, it looks in detail at the various elements of the TFES to assess how well they, individually and collectively, have operated to provide an accurate assessment of the sea freight cost disadvantage, any unintended consequences they have created and any distortionary effects they have had on undertaking Tasmania's freight tasks efficiently. Elements of the TFES that are considered include:

- the road freight equivalent, section 5.1;
- the door to wharf (and wharf to door) adjustment, section 5.2;
- scaling factors, section 5.3;
- the intermodal cost allowance, section 5.4;
- the median benchmark and sliding scale of rebate payments, section 5.5; and
- the density of cargoes, section 5.6.

In addition, the following more general features of providing assistance to offset the Tasmanian sea freight cost disadvantage are considered:

- the possible leakage of the assistance intended for producers to carriers and freight forwarders, section 5.7;
- participants' requests to expand the scope of the TFES, section 5 8;
- the suitability of the TFES for the Bass Strait Islands, section 5.9; and
- administration and compliance cost issues, section 5.10.

Evaluation of the TWFS is outlined in section 5.11.

In making its assessments, the Commission has had regard to the following general principles for good program design:

- As far as possible, assistance should be neutral in regard to producers' decisions about production methods and inputs.
- Any leakage of assistance to unintended beneficiaries should be minimised.
- To the extent possible, incentives for cost reduction and productivity improvement should be preserved.
- The assistance rules should be as simple and transparent as possible to avoid unnecessary administrative and compliance costs and to promote certainty for recipients about their entitlements.
- There should be appropriate mechanisms to minimise scheme manipulation, prevent fraud and, more generally, to monitor the impacts of assistance against objectives.

5.1 Road freight equivalent cost

The road freight equivalent cost estimate is the notional cost of moving the same goods an equivalent distance by road on the mainland. It is the benchmark against which the disadvantage of the Bass Strait sea freight cost is measured. As such, it underpins all TFES assistance calculations.

The TFES uses a single summary measure ($281 per TEU for dry cargo and 10 per cent more, or $309, for refrigerated TEUs) for the notional 420km road freight equivalent cost of a Bass Strait wharf-to-wharf sea freight task. But, in practice, different customers pay different road rates for road freight tasks of comparable distances. Road costs vary considerably, depending upon the nature and volume of the freight task, the extent of capacity, the timing of the service, the availability of backhaul freight and so on (chapter 3). And different comparison routes give different road freight costs. Prices may also differ between freight forwarders, trucking companies and owner-drivers. Large, regular shippers can command lower

road freight rates, while small, infrequent shippers generally pay more. Some participants argued that this may not always be the case. For example, Norske Skog Paper Mills suggested that:

> … a low volume shipper could be less disadvantaged in regards to land freight rates, as the capital required for a road transport 'unit' (i.e. truck and trailer) is considerably less than that required for sea freight. A relatively low volume shipper could fully utilize the capital or fixed component required for road transport and therefore not be as disadvantaged when compared to a large shipper. (sub. DR93, p. 4)

Nonetheless, when set against sea freight costs, which also vary between shipping tasks for much the same reasons (chapter 3), the use of a single road freight equivalent cost for all tasks necessarily leads to an under or overestimation of the actual sea freight cost disadvantage. The overestimates are more likely for small, infrequent shippers and for shippers of products which require more specialised transport. There may be underestimates for large, regular shippers. Given the limited amount of available data about road freight rates, it is difficult to measure the variance in road freight rates with any precision. The TFGA suggested that:

> … the general indication is that most road freight rates fall within a parameter band of probably something like 20 per cent plus or minus of what you might consider to be the average or, indeed, a median value … (trans., p. 98)

Moreover, road freight equivalents, however measured, also vary over time. In the more recent parameter reviews by the BTRE, the estimates of the (dry cargo) road freight equivalent varied from $315 to $324 per TEU (table 2.3). Based on information available to the Commission (including that shown in chapters 2 and 3), the current road freight equivalent would be substantially higher than the rate of $281 per TEU (recommended by the Nixon Review in 1998) presently used by the scheme.[1] This suggests that, if an updated road freight equivalent were implemented, there would be a substantial reduction in the measured freight cost disadvantage, and consequently a reduction in average levels of assistance.

Clearly there is considerable imprecision in the benchmark used. Nevertheless, it is not practical to estimate a notional road freight equivalent cost for each shipping task. The additional costs and the greater complexity of the scheme that would result from practical attempts to improve accuracy would outweigh any benefits. However, the road freight equivalent estimate should be subjected to periodic robust review.

1 For example, in responding to the Essential Services Commission on proposed rail access arrangements in Victoria in April 2006, Pacific National cited costs that would equate to a road freight equivalent across 420 kms in the order of $360: 'Road rates are in the range $1.65 to $1.72 per km which equates to $1825 to $1902 for the return trip of 553 km each way' (ESC 2006, p. 2).

FINDING 5.1

At the core of the TFES rebate calculation, a single estimate of the road freight equivalent cost is deducted from the varying sea freight costs of producers. However, those who incur higher sea freight costs would be likely to face higher land freight costs. In these circumstances, the underlying disadvantage is overestimated and a higher rebate is paid — this is a design weakness of the current TFES.

5.2 Door-to-wharf and wharf-to-door adjustments

While the TFES rebate is intended to be paid only on the Bass Strait wharf-to-wharf component of eligible sea freight journeys, about 85 per cent of all claims are for shipments made with at least one land transport component and therefore invoiced on a door-to-door, wharf-to-door or door-to-wharf basis (chapter 2).

To receive a rebate in these cases, a claimant can elect to have the TFES payment calculated in one of two ways. It can:

- submit the total freight bill to Centrelink, which will then calculate a notional wharf-to-wharf cost by applying the parameter adjustments outlined in chapter 2 — that is, $230 per TEU for each of the door-to-wharf and wharf-to-door land components (or $460 for a door-to-door bill); or
- advise Centrelink of the Bass Strait wharf-to-wharf component of the freight cost. Such information could be in the form of an itemised wharf-to-wharf cost, as shown on documentation prepared by a freight forwarder or agent, or an invoice from the carrier.

Claimants are free to choose how to claim in a manner that most advantages them, and the choice can lead to markedly different TFES rebates.

Who can claim?

There are three groups of claimants under the TFES: producers, registered southbound agents and other third parties. Claims can be made on the basis of wharf-to-wharf bills or by using the parameter deduction method, as described earlier.

Agents can assist some shippers by sorting out freight logistics, consolidating freight loads across clients to obtain better economies of scale when dealing with transport companies, and in some cases assisting in administering TFES claims.

The Nixon Review (1998) recommended against allowing parties other than shippers to claim assistance. However, in May 2002, the Ministerial Directions were amended to include 'southbound agents' in the TFES. Agents were permitted to act on behalf of TFES customers for southbound shipments for the agriculture, forestry and fishing industries. The change was intended to enable suppliers of services to these sectors, such as stock and station agents, to claim TFES assistance on behalf of their customers, thereby minimising the claiming, assessment and processing of multiple individual small claims. As outlined by DOTARS:

> Under the arrangements, the agent determines the level of TFES rebate payable and deducts this from the price of the goods purchased by the customer. The agent then claims and is reimbursed by the Australian Government for this discount through the freight equalisation scheme. Approved southbound agents typically pass on the TFES subsidy to their customers as a reduced sale price rather than as a retrospective reimbursement.
>
> Freight forwarders and freight logistics companies generate the documentation required to assess a TFES claim for assistance and are specifically excluded from the approved southbound agent arrangements. (sub. 53, p. 3)

Under the Ministerial Directions, Centrelink may audit approved agents to ensure that claims are being made in respect of eligible commodities and that the agent is passing the full amount of TFES assistance on to their individual customers.

The northbound eligibility criteria remained unchanged following the 2002 amendments. Accordingly, for northbound shipments, claimants who are not the producers and shippers of the goods — third party brokers, often referred to as 'agents' — are neither included nor excluded, explicitly, under the Ministerial Directions. This leaves the way open for them to take a role in developing subsidy claims. DOTARS said that this:

> … has enabled third party brokers to operate on the northbound freight route, offering freight rates and services net of the TFES rebate. As these brokers incur the cost for the freight task they are eligible to claim the TFES rebate. Unlike southbound agents, third party brokers are not subject to the controls applied to approved southbound agents. (sub. 53, p. 3)

Incentive to use the parameter adjustment method

If a door-to-wharf (wharf-to-door) cost component of a freight task is more than $230 per TEU, there is an incentive to submit a claim which relies on parameter adjustments to an overall freight bill. The deduction of the lower figure of $230 will result in a higher (calculated) wharf-to-wharf component and thereby a higher rebate than a bill that identifies the actual wharf-to-wharf cost component.

The more expensive the land transport component at either end (in excess of $230 per TEU) the bigger will be the TFES payment, if claimed on the basis of the total freight task (up to the subsidy cap of $855 per TEU). In this way, an advantage is given to those with higher door-to-wharf (wharf-to-door) costs — which would include those located furthest from the wharf and those with inefficient land transport logistics.

The Agricultural Contractors of Tasmania said that subsidisation of more than the sea component was not within the intent of the scheme:

> We have heard of mainland suppliers invoicing and receiving a rebate for more than the sea component of the journey. For example, the suppliers will invoice the trip as being from Melbourne to Campbell Town or Smithton, and receive assistance for the whole distance, instead of just the sea component.
>
> This gives the mainland suppliers an unfair advantage over Tasmanian Suppliers, and goes against the spirit of the Scheme. As the distance across the Bass Strait will not ever change, we believe a flat, transparent fee would be more appropriate. (sub. 8, p. 1)

Conversely, if the land transport cost is less than $230 per TEU, the shipper has an incentive to submit actual wharf-to-wharf costs. Otherwise, use of the parameter adjustments would result in a lower (calculated) wharf-to-wharf cost and therefore a smaller rebate.

As with all parameters that determine TFES rebates, the $230 per TEU is an approximation of an average door-to-wharf or wharf-to-door task. Prior to the Nixon Review, the deduction was $200. The review proposed $300, but this was challenged by participants in that review, some of who proposed a rate as low as $160 (and the lower the deduction, the higher the rebate). The final recommendation of $230 was a compromise (the average of $160 and $300). This was adopted following the Nixon Review of 1998 and has remained unchanged since, although the most recent parameter review suggested a rate of $258 per TEU (which would further lower the rebate) (table 2.3).

Notwithstanding the value set for this parameter, the actual costs of door-to-wharf and wharf-to-door journeys vary considerably across shipping tasks. Consequently, the $230 per TEU by itself can overcompensate for the cost of particular shipping tasks.

Incentives to seek or provide higher wharf-to-wharf invoices

Some participants advised that the claiming procedures under the TFES provide an incentive for some shippers to ‘shop around’ for the most advantageously structured freight bill for TFES subsidy purposes. Kelly and Sons said that it:

> … has seen buyers actively choosing the grain offer with the biggest associated TFES subsidy when choosing between multiple offers that provide broadly the same net cost … (sub. 30, p. 6)

In this way, the extent of freight cost disadvantage is being overstated and some shippers are being overcompensated. This can lead to the result that the cheapest form of transport is not always the one chosen — shippers may use a higher cost freight service because it provides a lower freight rate net of the TFES subsidy.

Agents have considerable expertise and knowledge of the industry and therefore are well placed to maximise the gains from their use of the TFES for their clients. Warwick Counsell said:

> Since 2002/3 at least, Centrelink has allowed 'agents' (but not shippers) to convert what should be door-to-door claims into wharf-to-wharf claims by producing their own wharf-to-wharf freight bills. … These artificial wharf-to-wharf freight bills are designed by the agents to support a larger claim than would otherwise be available under the scheme. (sub. 18, p. 4)

The Victorian Government observed that:

> Companies which are able to bundle total costs due to either vertical integration or contractual bundling with relevant freight forwarding companies would be likely to receive custom from shippers wishing to 'game' the scheme to their advantage. The scheme is therefore likely to be inadvertently subsidising some land freight costs. This incentive problem is exacerbated by the fact that discrete elements of the freight task are not transparent on bundled bills, which in turn provides at least some potential for freight companies to inflate costs on any of the transport components. (sub. 60, p. 17)

The Tasmanian Transport Association argued for greater simplification of the TFES to limit the role of third parties. It said:

> The TFES must be structured in a manner which provides for the subsidy to be available only to the manufacturer or the producer and ensure that no third party has any financial gain. Every extra dollar that is gained by manipulation of the scheme only puts the future of the scheme in jeopardy.
>
> To eliminate any manipulation [of] the TFES it should be structured so that the refund is calculated around the standard shipping containers, or equivalent, on a wharf to wharf basis only with no avenues open to permit anybody other than the correct claimant receiving the subsidy. (sub. 5, p. 1)

The root cause of the problem is the design of the TFES, which intentionally allows different ways of claiming rebates, and which therefore provides incentives for claimants to rearrange their affairs so as to minimise freight costs by maximising their entitlements under the scheme. At the heart of the problem is the prevalence of door-to-door, wharf-to-door or door-to-wharf freight services, and the problems of

determining an arm's length wharf-to-wharf component against which to estimate freight disadvantage and pay a rebate.

A consequence of this, as noted in chapter 3, is that the opportunity to exercise choice provides an in-built incentive for wharf-to-wharf costs reported to Centrelink to be higher on average than would otherwise be the case. This in turn suggests that the wharf-to-wharf freight cost disadvantage, as calculated from the TFES database, is misleadingly higher.

A number of participants also drew the Commission's attention to what Net Sea Freight has described as the opportunity for fraud under the current scheme design:

> The potential opportunity for fraud increases where claims are prepared by shipping companies, freight forwarders, or agents of these two parties, on behalf of eligible claimants or in fact themselves. Fraud is possible where the one entity sets, or contributes to, the freight rate, validates this rate in writing to the TFES, and prepares and submits the claim. For example, fraud could be perpetrated by determining a sea freight rate by deducting as little as $1 from the door-to-door rate, i.e. a shipper could be quoted a door-to-door rate with a very small invoiced road freight rate, so that the blue water charge becomes very high, on the basis that part of this can be claimed back under the assistance process. Alternatively, a shipping company could supply a shipper with on-site plant and equipment the cost of which is incorporated into the cost of shipping. Again, a shipping company or freight forwarder could maintain an inflated freight rate and offset this expense by provision of, say, a suite of computers to a client. Such largesse is unlikely to be declared as a freight rebate in the required statutory declaration. (sub. 26, pp. 21–22)

Net Sea Freight also said that vertical integration enhances the ability of a shipping company to hide land transport costs within a wharf-to-wharf rate (sub. 26, p. 13).

One participant submitted a hypothetical case which demonstrated that significantly different TFES payments could be generated from the one Bass Strait freight task by reporting different wharf-to-wharf costs (box 5.1).

What changes could be made to address these problems?

One way of addressing these adverse incentive effects and the potential for manipulating the scheme would be to no longer use the door-to-wharf and wharf-to-door parameter adjustments and instead to require a carrier's original wharf-to-wharf freight bill as a precondition for the TFES payment.

There was some support for this approach. The Tasmanian Transport Association said:

> The TFES should only be payable on the presentation of an itemised wharf to wharf copy of the actual shipping invoice. (sub. 5, p. 2)

Box 5.1 **Scope for significantly different TFES payments for the same door-to-door trip**

Warwick Counsell submitted the following hypothetical case to demonstrate that the same Bass Strait trip could generate significantly different TFES payments.

1. A producer who has paid $1200 to transport one 20' container from his Hobart plant to his customer's depot in suburban Melbourne (and did not obtain a wharf-to-wharf freight bill) would be obliged to make a door-to-door claim based on a notional wharf-to-wharf bill derived by deducting the door-to-wharf component ($230) and the wharf-to-door component ($230) and scaling the balance (dividing by 1.3) to eliminate the Hobart to Devonport leg. His notional wharf-to-wharf freight bill would be $569 and the assistance payable would be $388.

2. If the same producer submitted a wharf-to-wharf freight bill of (say) $700 with his claim, he would receive assistance of $498.

3. An agent making a claim for the same shipment could produce an artificial wharf-to-wharf (Devonport wharf to Melbourne wharf) bill of (say) $1020 (pretending that the cost of transport from the Hobart depot to the Devonport wharf AND from the Melbourne wharf to the depot in suburban Melbourne was $180) and receive assistance of $721.

Source: Warwick Counsell (sub. 18).

Norske Skog said it would be happy to see claims restricted to a wharf-to-wharf basis, but noted that this may unnecessarily impact on other shippers (sub. 24, p.19). Net Sea Freight said that while this approach would not present a problem for full container load shipments, the option to lodge assistance claims for less than full container load (LCL) shipments on a door-to-door basis should be retained:

> If freight forwarders charged shippers on a wharf-to-wharf basis, it would not be practical for LCL shipments, as paperwork would have to be supplied breaking down costs among shippers, and would increase the complexity of administering the scheme. (sub. 26, p. 21)

Kelly and Sons said that paying on a wharf-to-wharf basis would make the subsidy more transparent, easier to monitor and administer, and less susceptible to abuse (sub. 30, p. 8). At the draft report hearings, representatives of the major Tasmanian manufacturers also expressed support for this approach (see chapter 7).

However, reliance on original invoices is not foolproof as it relies on accurate and truthful disclosure of wharf-to-wharf costs. The Nixon Review expressed concern about the difficulty of achieving this:

> The Authority considered various options for requiring or inducing freight forwarders to disclose a relevant wharf gate to wharf gate component for assistance purposes. It concluded that truthful disclosure would be difficult to obtain and costly to verify. Incentives to overstate the component based on sweetheart deals between freight forwarders and their customers would remain. (1998, p. 13)

Because of concern about freight forwarder confidentiality and the prevalence of door-to-door freight arrangements, Nixon did not recommend that the TFES be based only on wharf-to-wharf claims:

> … any disclosure requirements that require freight forwarders to detail the logistics solutions they arrange will expose items of a commercial-in-confidence nature, compromise the freight forwarder's role and may even result in the activities being curtailed. (1998, p. 13)

G.J. Sales reiterated this confidentiality issue:

> Because of the highly competitive nature of the industry, for Shipping Lines, Transport Companies and Freight Forwarders, like myself, it would be deemed as undesirable for our freight charges to our clients be broken down to suit a different system of claiming TFES. For instance, I am quite sure that none of us want sea freight charges exposed, as they vary from line to line for various and good commercial reasons. (sub. 1, p. 2)

Patrick McNamara (sub. 27) strongly questioned the confidentiality concern.

In the Commission's view, concerns about confidentiality, and about the changes that would be needed to invoicing procedures, should not lead to rejection of this approach. The market for freight services can be expected to adjust to meet the demands of TFES claimants under new rules.

However, in view of the prevalence of door-to-door charging, shipments in less than full container loads, and multiple customers, there are some hurdles that would need to be overcome before it could be implemented. In addition, concern as to the truthfulness of all wharf-to-wharf invoices presented in support of a subsidy would remain an issue. The Commission's views on how these issues might be addressed are reported in chapter 7.

The Commission notes that there are differences in the requirements placed on registered southbound agents and other non-producer claimants, and considers that there may be a case to subject all such groups to the same rules and audit controls. This would allow greater scrutiny of the activities of all such claimants and, particularly in view of the concerns expressed by some participants, could provide a measure of reassurance as to their role.

More broadly, there may also be scope for an improved monitoring, audit and penalty framework to deter invoice manipulation. In this respect, the view was expressed to the Commission that current Centrelink administration arrangements should be enhanced. But as it is impractical to audit every transaction, appropriate penalties may also need to be considered.

FINDING 5.2

Many TFES recipients expressed concern about the manipulation of subsidy claims through the ability to choose the method of claiming.

- *Use of a fixed $230 per TEU land freight cost deduction to derive a notional wharf-to-wharf cost provides an incentive for those with higher land freight costs to claim on a door-to-door basis.*
- *The design of the scheme also provides an incentive for those who claim on a wharf-to-wharf basis to report and claim the highest possible wharf-to-wharf cost for a given door-to-door invoice.*

Consequently, the extent of wharf-to-wharf freight cost disadvantage is overestimated and results in higher rebates being paid. The scope for this cannot be eliminated within the current design of the TFES.

5.3 Route scaling factors

When a shipper presents a freight bill for a route other than between northern Tasmania and Victoria, the wharf-to-wharf component of that bill is adjusted downwards by a scaling factor, so as to express it as a Bass Strait wharf-to-wharf equivalent. The current scaling factors were estimated in 1996-97 on the basis of average capital city door-to-door cost differences (Nixon 1998, appendix A, p. 13). In 2005-06 about 21 per cent of TFES payments were for routes where scaling factors were required (table 5.1).

There are two concerns with scaling factors. The first is with the estimation of the current values. As shown in table 5.1, previous reviews have consistently estimated lower scaling factors for nine of the eleven routes. For example, the current scaling factor for the northbound New South Wales route is 1.8 whereas the annual reviews suggest a New South Wales scaling factor no higher than 1.5. The use of 1.5 instead of 1.8 would result in an increase in a median claim by $68. 'Errors' in the route scaling factors can have a significant impact on an individual claim.[2]

In the context of a scheme aimed at freight disadvantage, it is important that route scaling factors accurately reflect the sea freight costs — and thus disadvantage — of different routes compared to the Bass Strait. As Patrick McNamara noted, for some

[2] A 10 per cent error in the scaling factor for the northbound NSW route (currently 1.8) would mean a revised estimate of 1.62 or 1.98 and change a median claim of $671 per TEU by either $34 per TEU (gain) or $41 per TEU (loss).

routes, the sea freight rates from Tasmania can fall below comparable land freight costs:

> This actually happened in the early years of the scheme, when it was found that the net cost of shipping cargoes from Tasmania to Perth was less than the land freight rate from Melbourne to Perth, even though the cargo was carried on Australian-flag ships. (Indeed, for high density commodities, the Tasmanian freight rate might have been the lower even before TFES subsidy.)
>
> This reflects the fact that sea-transport becomes more competitive with land transport as route distance increases. Over long distances, sea is the cheaper mode, and the Melbourne-Perth route was getting close to the point of equality. It is noteworthy that sea was competitive with land transport on this route, even back in the 1970s, when coastal container freight was carried by high-cost, Australian-flag, vessels. (sub. DR90, p. 1)

Table 5.1 **Estimates of route scaling factors**

Route	*Percentage of claims (by value) 2005-06*	*Review Authority 1996-97*	*Annual review estimates* Low	High
Northern Tasmania to/from:				
Victoria	79	1.0	na	na
New South Wales	4	1.8	1.4	1.5
South Australia	1	1.5	1.3	1.4
Queensland	3	2.4	1.7	2.3
Western Australia	4	2.5	1.3	2.2
Northern Territory	0	6.8	3.6	6.1
Southern Tasmania to/from:				
Victoria	5	1.3	1.0	1.3
New South Wales	2	1.9	1.6	1.7
South Australia	1	1.3	1.2	1.8
Queensland	1	2.2	1.7	1.9
Western Australia	0	2.4	1.5	2.0
Northern Territory	0	4.6	3.2	6.0

Source: TFES database and Commission calculations.

The second concern about scaling factors is that they are based on capital city cost differences, but apply to activity throughout an entire state. This creates competitiveness problems near borders. Hypothetically, consider the case of wheat farmers just either side of the Victoria–New South Wales border. Under the TFES, if a New South Wales farmer sends his wheat to Tasmania via Melbourne *and submits a door-to-door bill,* the scaling factor for New South Wales is applied (1.8), not the Victorian scaling factor (1.0), as the Ministerial Directions determines the

assistance point of origin to be where the shipment commences (clause 19.3(b)). At the same time, a Victorian wheat farmer just inside the border, and essentially charged the same gross door-to-door cost is subject to the Victorian scaling factor and would get a higher TFES payment than the New South Wales farmer.

FINDING 5.3

The majority of route scaling factors, estimated in 1996-97, are higher than the estimates in subsequent parameter reviews. A higher estimate results in a lower TFES rebate.

5.4 Intermodal cost adjustment

Under the TFES, a fixed amount of $100 per TEU is added (for all shippers) to the notional wharf-to-wharf cost in order to establish the notional entitlement (or disadvantage). The $100 is intended to approximate intermodal costs of using shipping (notionally $50 per TEU either end). Some participants argued that this is insufficient (see chapter 3).

The Nixon Review (1998) recommended that the fixed intermodal cost should be updated using the transport and storage component of the consumer price index. That recommendation was not accepted. The BTRE estimated that, on the basis of indexation only, the combined intermodal cost would have been $113 per TEU in 2002-03 (chapter 2, table 2.3). It added that it may now be time for the intermodal cost to be reviewed in more detail, using a sample of shippers' costs, rather than annual indexation.

On the face of it, shippers may be undercompensated for this cost component. However, as noted above, it is not always clear which costs are allocated to wharf-to-wharf and door-to-door invoices. There is an incentive to include as much of the intermodal services in the wharf-to-wharf bill as is possible, and then claim the additional $100 per TEU allowance.

The alternative of explicitly listing eligible wharf-to-wharf costs that could be claimed is not without problems, either. The Nixon Review argued for a fixed allowance on the grounds that:

- intermodal activities may take place inside or outside the wharf gates, and an explicit attempt to list eligible wharf gate to wharf gate costs would provide an inappropriate incentive to shift intermodal activities;
- an explicit approach would add unnecessary administration costs from attempting to verify (audit) claims for intermodal costs; and

- the majority of claims (75 per cent) at the time were on a door-to-door basis, with no disaggregation of wharf-to-wharf costs.

Veolia Environmental Services stated that if there was a move away from a fixed intermodal allowance to permitting claims on the basis of a declared wharf-to-wharf component of a door-to-door charge then:

> … some clarity is required on what costs make up the wharf-to-wharf component. Declarations made to us by freight forwarders have varied significantly for the same transport legs. (sub. 21, p. 2)

FINDING 5.4

The intermodal cost allowance provides an incentive for shippers to seek wharf-to-wharf invoices that include as many intermodal services as possible, to which the allowance is then added. This results in a higher TFES rebate.

5.5 The median wharf-to-wharf disadvantage, class thresholds and sliding scale parameters

The TFES uses a median level of wharf-to-wharf disadvantage to classify claims into four classes of shipment on the basis of their estimated notional wharf-to-wharf disadvantage. Different levels of rebate are paid to each class:

- *Class 1*: defined as shipments with an estimated wharf-to-wharf disadvantage of one-half or less of the median. For these shipments, the full extent of the estimated disadvantage is rebated.
- *Class 2*: defined as shipments with an estimated wharf-to-wharf disadvantage of the median or less and greater than one-half the median. For these shipments, the rebate includes all the first half of the median disadvantage, plus 75 per cent of any estimated disadvantage above that level.
- *Class 3*: defined as shipments with an estimated wharf-to-wharf disadvantage of 1.5 times the median or less and greater than the median. For these shipments, the rebate includes all the first half or the median disadvantage, plus 75 per cent of the second half of the median disadvantage and 50 per cent of any estimated disadvantage above that level.
- *Class 4*: defined as shipments with an estimated disadvantage greater that 1.5 times the median. These shipments are paid the maximum rebate for wharf-

to-wharf disadvantage (of $755 per TEU) irrespective of the extent of the greater estimated disadvantage.[3]

Incentive effects

The resultant sliding scale of rebates (chapter 2, figure 2.2) provides shippers with widely different incentives to seek sea freight cost savings, depending on their estimated wharf-to-wharf disadvantage. For class 1 shippers, the incentives are very weak as any cost saving negotiated with carriers is fully offset by a corresponding reduction in their TFES rebate. In contrast, for class 4 shippers, normal commercial incentives apply as shippers retain the full value of any sea freight cost saving they negotiate, if above the class 3 threshold. For class 2 shippers, the cost savings incentives are weak when the reduction of the TFES rebate is taken into account, as they retain only 25 cents in the dollar of any sea freight cost savings they obtain. (Equally, they get back 75 cents in the dollar from the TFES of any freight increases.) Class 3 shippers have stronger incentives as they retain half of any sea freight cost savings.

The sliding scale of rebates may be viewed as a fixed rate of rebate set at one-half the median ($335.5 per TEU), with full rebate recovery of any lower estimated disadvantage, and a declining variable additional rebate for higher estimated disadvantages, up to a maximum of 1.5 times the median. The incentive effects of the current sliding scale of rebates are set by the full recovery and the declining variable additional rebate — that is, by the proportion of the estimated disadvantage rebated. There is a basic incompatibility between providing a full rebate of estimated disadvantage and retaining normal commercial incentives to reduce costs.

The importance of the median, class thresholds and sliding scale of rebates was recognised when advocated by the Nixon Review. It said:

> The distributional, incentive and budgetary impacts of the scheme depend on the choice of [these] key parameters … (Nixon 1998, p. 27)

The Commission concurs with that assessment.

Choice and estimation

The choice of median was based on the Nixon Review's view that the TFES should use a 'typical' sea freight cost disadvantage as a reference point for determining

[3] The Nixon Review also considered that the capping of rebates was warranted '… to prevent greater assistance to shippers who have a relatively large land component in their door to door rates' (1998, appendix A, p. 3).

assistance. It considered that the median shipper's costs best reflected this. It held that the choice (between the median and say an average) involved balancing conflicting considerations. On the one hand, it considered that average freight rates per TEU were likely to be heavily influenced by a few very large shippers that negotiated relatively low freight rates and accounted for a high proportion of all TEUs shipped. On the other, it considered that the choice of 'median shipper' could be significantly influenced by the large number of shippers that shipped only one or two full containers per year on a wharf-to-wharf basis at high freight rates. It held that:

> To balance these influences the Authority has adopted the following approach. The population of *wharf to wharf shippers,* for purposes of determining a median wharf to wharf freight rate for Bass Strait, is taken as all those who ship five TEUs or more annually on a FCL [full container load] basis.
>
> To these are added the population of all door to door shippers, both reefer and non reefer, after notional adjustments have been made for door to wharf and wharf to door costs. (Nixon 1998, p. 28) [emphasis in original]

As indicated, the population of shippers was limited to those using Bass Strait and included shipments both northbound and southbound between northern Tasmania and Victoria. Shipments to and from other ports were excluded from the population for its estimation. The Nixon Review used the data available from the TFES to find the 1996-97 median shipper's estimated wharf-to-wharf disadvantage, and the value of $671 per TEU has been used to set the TFES thresholds since June 1999.

The Nixon Review also recognised that the thresholds and sliding scale of rebates involved arbitrary choices and advocated that 'These "steps" in the assistance schedule should be kept under review for their effect on a sample of shippers at different points in the spectrum of sea freight cost disadvantage' (1998, p. 29). Such analysis does not seem to have been conducted as part of the annual parameter reviews.

The effects of the Nixon Review choices are indicated in table 5.2, where the proportion of claimants and proportion of TEUs shipped for each class of shipment are given for:

- the Bass Strait sample, as suggested by the Nixon Review for the determination of the median; and
- the population of all full container load claims on all routes.

There are some similarities between the samples. In both cases:

- the shipments of about one-third of all claimants (56 to 67 per cent of TEUs) fall into classes 1 and 2 for TFES purposes. For these shipments, there is only a weak incentive (if any) for shippers to seek lower sea freight costs.

- some 40 per cent of shippers are classified to class 4 and receive the maximum rebate. These shippers cover only some 8 to 9 per cent of TEUs. The normal commercial incentives to seek lower sea freight costs would apply to these shippers as they would directly benefit from any negotiated reduction in shipping rates.

Table 5.2 **Grouping claimants and TEUs by TFES shipment class, 2005-06**

	Class range	*Bass Strait claims, with five or more FCLs*[a]		*All routes, all FCL claims*	
Class	*Notional WTW*[b] *disadvantage*	*Claimants*	*TEUs*	*Claimants*	*TEUs*
	$	%	%	%	%
1	0 to 335.5	5.9	3.8	6.4	27.3
2	335.5+ to 671	29.0	52.0	26.1	39.5
3	671+ to 1006.5	26.7	35.3	26.1	25.2
4	1006.5+	38.4	8.8	41.4	8.0
All	Total[c]	100.0	100.0	100.0	100.0

[a] Based on Nixon Review criteria of full container loads (FCL), all freight claims and of shippers sending five or more TEUs. [b] WTW is wharf-to-wharf. [c] Totals may not sum to 100 due to rounding errors.

Source: TFES database.

The annual recalculation of the median has shown more volatility than any of the other parameters of the TFES. As indicated in chapter 2, table 2.3, the recalculated median has varied from a low of $519 per TEU, as calculated by the BTRE from 2000-01 TFES data, to a high of $687 per TEU, as calculated by the CIE from 1999-00 TFES data. The most recent estimate, calculated by the BTRE from 2002-03 TFES data was a median value of $610 per TEU.

Use of values lower than the current median value of $671 per TEU would have the effect of reducing cut-off values for the definition of shipment classes and result in more shipments being classified in higher shipment classes for rebates purposes. This would lower the rebates payable for those classes and lower the overall expenditure on the scheme. Notwithstanding this, as noted earlier (chapter 2), the overall reduction would have been small. This reflects the high level of rebates for most shipments, the relatively small proportion of class 4 shipments and the small reduction in rebates that would accompany any movements from class 1 to class 2 and from class 2 to class 3. There could, however, be quite substantial changes in the rebates for some shippers.

An illustration of the volatility of the median is also provided by using different values for the exclusion of shippers with a small numbers of full TEUs for its determination (table 5.3). With exclusion values of one or more, five or more and 10 or more, the corresponding median values are $922 per TEU, $819 per TEU and

$795 per TEU, respectively. It should be noted that these estimates are inflated by the biases introduced into the estimates of notional wharf-to-wharf disadvantage discussed above, especially through the inclusion of door-to-door, door-to-wharf and wharf-to-door claims in deriving the estimates.

Table 5.3 **Median and average values of wharf-to-wharf disadvantage by exclusion of small shippers,[a] 2005-06**

$ per TEU

	Full container cut-off value		
	1 or more	*5 or more*	*10 or more*
Median shipper	922	819	795
Average (weighted mean)	603	602	600
Standard deviation	507	483	448

a Based on full container loads and all types of freight claims for northern Tasmania to and from Victoria (routes G and S).

Source: TFES database.

Use of 2005-06 data to reset the median (that is, the Nixon Review criteria of five or more full TEUs) provides a new estimate of the median ($819 per TEU) for setting shipment class boundaries. This would raise the rebates payable and the overall cost of the scheme. More shippers would fall into classes 1 and 2, implying that they would have little or no incentive to seek out lower freight rates.

The Nixon Review had advocated annual recalculations of the median wharf-to-wharf disadvantage using the TFES database. It also held that 'Other characteristics of the distribution of the wharf to wharf disadvantage, such as the mean and standard deviation, should also be observed for the purpose of assessing any year to year changes and identifying the causes of any such changes' (Nixon 1998, appendix A, p. 12).

Calculation of these values for the Bass Strait sample shows (in table 5.3) that, in contrast to the median (which varied by over $100 per TEU), there was little change in the average value (which varied by $3 per TEU) as the cut-off value was raised from one to ten. Reflecting the wide variation in disadvantage estimated for small shippers, the standard deviation systematically declined from $507 per TEU to $448 per TEU as the cut-off value was raised from one to ten. As with estimates of the median, the estimates of the average and standard deviation are inflated by the biases introduced into the estimates of notional wharf-to-wharf disadvantage discussed above.

FINDING 5.5

The design of the class cut-offs (based on the median) and the associated sliding scale for rebate payments provide weaker than normal commercial incentives for cost minimisation for the majority of shipments. The use of the median exacerbates this.

5.6 Reduced assistance for high density cargo

Density of cargo is measured by its stowage factor (tonnes per cubic metre). A standard TEU has a volume of around 30 cubic metres. A full container with a stowage factor of 1.0 would weigh 30 tonnes and, with a stowage factor of 1.5, would weigh 20 tonnes.

The density of cargo affects the cost of road transport and shipping differently. Road transport vehicles can carry up to two TEUs if the density of the cargo is not excessive, but only a single TEU for high density cargo. Therefore, the road cost per TEU increases at high density. In contrast, container carrying ships are not so limited by the density of the cargo. Rather, they are limited by space and the weight bearing capacity of the loading equipment. Thus, compared with standard weight cargo, high density TEUs can be freighted by sea with minimal, if any, additional cost.

Under the TFES, the road freight equivalent (currently $281 per TEU) is based on the movement of two TEUs per truck. As such this would under-estimate the road cost of moving high density product of, say, a single TEU weighing 30 tonnes. Rather than attempt to establish a separate (higher) road freight equivalent for high density cargo, the Nixon Review recommended a 40 per cent discount in assistance payable for high density cargo.

The Nixon Review acknowledged that the discount of 40 per cent is only an approximation. Patrick McNamara (sub. 27, p. 10) commented that shipping documents for the period 1976 to 1985 confirmed that high density cargoes suffered a lower level of transport disadvantage. He also provided calculations based on hypothetical freight rates showing that the 40 per cent is a reasonable approximation for cargoes with stowage factors of about 1.5 and 2.0. On the other hand, a single quote obtained by Circular Head Dolomite (sub. 87, para. 5) comparing B-double and single reefer road costs for its high density dolomite suggests a discount of 30 per cent may be more relevant.

Circular Head Dolomite (CHD) pointed out that, while the high density adjustment is theoretically logical, it may still result in unintended adverse effects:

> CHD could ship unrefined dolomite rock in containers and receive the full Low-Density rate. The rock could then be crushed offshore. This goes against the fundamental philosophy of the TFES to encourage value adding of products in Tasmania. … CHD wishes to neither engage in practices of undermining the current scheme or retrenching part of its workforce. (sub. 41, p. 3)

It added that:

> Because [dolomite] can be broadly described as a commodity (low per unit value) the difference in subsidy between Low and High-density, amounts to $10/tonne. The impact on landed product sale price is however in the order of 20%, and is the difference between a viable and non-viable export operation. (sub. DR87, p. 2)

The high density issue is a good example of the complexity involved in attempting to design a scheme based on sea cost disadvantage, that is equitable between commodities and that does not distort efficiency. As the Nixon Review put it:

> The heavy weight adjustment issue highlights an incompatibility between the objective of using a road freight equivalent per TEU, adjusting assistance per TEU based on a single RFE to reflect the smaller disadvantage experienced by heavy TEUs and the objective of ensuring that freight is moved in the most efficient configurations. (1998, p. 23)

FINDING 5.6

A discount of assistance for high density cargo recognises its higher road freight equivalent cost compared to standard weight cargo. However, the size of that discount may no longer reflect current road transport costs.

5.7 Potential leakage of subsidy to carriers and freight forwarders

The TFES relies on claims by Tasmanian shippers to ensure that the subsidy benefits them directly. However, the benefit would be somewhat diluted if shipping companies gross up their freight rates in the knowledge that recipients will be compensated through TFES payments. Net Sea Freight (sub. 26, p. 14) said that it is likely that shipping companies do appropriate part of the assistance and that they do take notice of the availability of subsidies when setting rates.

The degree of subsidy leakage depends, in large part, on how competitive the Bass Strait shipping market is. One view is that it is very competitive, as possibly suggested by: reductions in real freight rates in recent years; excess capacity; substitution away from air freight at the high value end; and innovations for clients.

Net Sea Freight (sub. 26, p. 12) claimed that freight rates would have been 20 to 30 per cent higher if not for the competition from the privatised ANL, and that the TT line had also assisted in keeping rates lower than otherwise. One participant said there was a once per week service by international carriers — one vessel, operated by a group of different shippers with different freight rates — which also provides some competitive pressure. In the opinion of Cascade Brewery:

> There does not appear to be any misuse of power by Bass Strait shippers, and freight rates for the Bass Strait route appear to be in line with mainland routes when considering the increased complexity of the combined land & sea freight modes involved in this route. (sub. 4, p. 2)

A contrasting view is that there is more than one Bass Strait market, as the shipping task can be disaggregated by route, freight configuration, service frequency and the like. Consequently, there may be much less reserve capacity in some of the sub-markets, especially seasonally, and competition may not be as keen. King Island is regularly highlighted as a separate shipping market, as air freight is the only competition to the sole supplier of shipping services.

A key to competitive outcomes is contestability. This in turn is related to whether there are regulatory and/or non-regulatory barriers to entry. There are no regulations barring entry by new domestic carriers. However, Net Sea Freight said:

> The industry is not, in practice, contestable, in the sense that threats of entry would otherwise ensure competitive behaviour on the part of shipping companies. Entry costs are relatively high (due to the difficulty of obtaining tonnage of suitable design) and exit costs (sunk costs in the form of having difficult-to-sell shipping in the event of fire sale market conditions) would also make potential entrants cautious. (sub. 26, pp. 12–13)

The ACCC (2006) considered that barriers to entry into Bass Strait shipping were high, one reason being there is very little opportunity for a new entrant to gain access to berths, or develop additional berths within the Port of Melbourne. It also identified the effect of vertical integration between carriers and freight forwarders, high capital costs (without guaranteed volume) and the deterrence posed by current excess capacity.

While there are no regulatory barriers to domestic entrants, there are for international carriers (see chapter 3), though this may have little practical impact. Participants (including, Norske Skog, Net Sea Freight and ANL) claimed that reforming the single and continuous voyage permit regime for international shipping would make little difference to competition across Bass Strait unless there was a daily service.

A number of participants were concerned about the competitive implications of the Toll takeover of Patrick. The ACCC considered that the takeover would otherwise have the effect of substantially lessening competition in the market for Bass Strait shipping services and freight forwarding (in contravention of section 50 of the *Trade Practices Act 1974*) but that the Enforceable Undertaking given by Toll sufficiently addressed its competition concerns (2006, paragraphs 72 and 77). Net Sea Freight (sub. 27, p. 12) speculated that no line is presently making a satisfactory profit, especially with the TT Line losing money, and that rationalisation and higher freight rates are likely in the medium term.

The competitive position facing shippers depends upon their bargaining power. Medium to large shippers are more likely to be able to negotiate better rates, by virtue of being 'anchor' clients. Small shippers individually have less bargaining power and use freight forwarders, in part to obtain better rates. They also acknowledge that they benefit from the large shippers underpinning the provision of regular services.

Carriers' charges are just one element in the entire freight forwarding package. Thus, it is the competitiveness of the freight forwarding door-to-door market that matters for many shippers. Not surprisingly, freight forwarders claim this market is highly competitive. There are many more freight forwarders than carriers, which some see as giving rise to competitive outcomes. Freight forwarders, particularly those which handle large volumes, are said to be able to bargain with shipowners for preferential rates. However, others note that some forwarders are vertically integrated with shipping companies, and some are very small independent operators.

From the limited information available, the Commission has not been able to estimate the level of leakage, if any, to carriers and freight forwarders. And, it is not clear that the TFES itself could be changed to minimise that potential effect, particularly if it is to remain in its present form as a freight cost subsidy.

An alternative to the TFES, suggested by some participants (for example, Peter Brohier, trans., p. 11), would be for the government to tender for the shipping service, relying on the bidding process to compete away any appropriation of the subsidy by carriers. Subject to the design of the tender, a potential difference between such a tender and the current TFES is that all Tasmanian shippers would benefit from any lower freight rates. However, there seems no compelling reason why the bidding process would be any more competitive than the daily bidding for freight tasks by freight forwarders and carriers. Moreover, perhaps the greatest

concern would be the difficulty for a government of appropriately specifying the dimensions of the shipping task.[4]

Finally, the case for tendering a community service obligation is usually based on providing a service where a commercial basis for one does not exist (such as ferry services to small isolated islands to underpin basic living). In contrast, Bass Strait is already supplied by four commercial lines.

The Commission considers that competitive tendering to supply the Bass Strait sea freight subsidy would raise more substantial problems than any small benefit it may deliver.

FINDING 5.7

If the Bass Strait freight market is not fully competitive, there may be some leakage of the subsidy away from intended beneficiaries to the shipping lines.

5.8 Calls for changes in eligibility

The northbound component of the scheme covers eligible goods produced or manufactured in Tasmania for permanent use or for sale on the mainland of Australia. The southbound component covers eligible non-consumer raw materials, machinery and equipment shipped from the mainland for use in manufacturing, mining, agriculture, forestry and fishing industries in Tasmania. Eligible commodities are listed in the Ministerial Directions.

Consumer goods, imports, goods intended for export, bulk commodities and the back hauling of some empty containers are not eligible for TFES assistance. As the TFES applies to containerised sea freight, goods shipped by air are not subsidised.

Many participants called for several changes to eligibility. All but one argued for a widening of the scope of goods covered by the scheme.

[4] If a government takes a broad approach to a community service obligation tender and specifies say, the number of annual crossings or total tonnage there is a real danger that the winning carrier would reconfigure services to the detriment of some customers, in order to maximise its margin on the government's payment while appearing to meet the contracted amount of service. On the other hand, if a government minutely details the shipping task, then the service will not be responsive to changing market conditions. Tendering for shipping is probably easier for homogenous tasks such as a regular ferry service. The Bass Strait freight task is far from homogenous.

Exports and imports

Participants who called for exports to be eligible for northbound assistance to the mainland prior to export included:

- Agricultural Contractors of Tasmania (sub. 8);
- Cuthbertson Bros (sub. 20);
- Fruit Growers Tasmanian Inc (sub. 32);
- Caterpillar Underground Mining (sub. 36); and
- Tasmanian Lupini Enterprises (sub. 61).

The Nixon Review was of the view that inclusion of exports would likely compromise Australia's World Trade Organization (WTO) obligations. Patrick McNamara (sub. 27) questioned whether a firm legal opinion had been given on this matter. The Review was also concerned that including exports would endanger the frequency of liner shipping calls to Tasmanian ports, as it would be expected to encourage more export freight to be diverted to Melbourne for export. However, as Tasmanian Lupini Enterprises noted, even though the TFES was not extended to exports, changes in global liner shipping have meant that:

> The frequency of liner ships calling into Tasmania has reduced significantly … over the last 5 years which has necessitated the need to tranship produce to Melbourne ports at considerable extra cost. (sub. 61, p. 2)

As such, concerns regarding liner shipping may be less relevant today than at the time of the Nixon Review. Nonetheless, it remains that expansion of the TFES to explicitly take exports into account could raise WTO issues.

A related issue is the particular degree of mainland processing (before final export) necessary for a product to qualify as eligible for TFES payments. Caterpillar Underground Mining, which exports 56 per cent of its production from its Burnie facilities, was unsure whether it could claim under the TFES for mainland processing of this production, saying:

> … it was highlighted to us [in 2003] that should our company embark on manufacture of any component for our product on the mainland prior to being shipped internationally, we could claim said rebate. However, as this clause is subject to conjecture we preferred not to pursue claims through 2004, 2005 and to date this year for products which have been exported, even though we have during this time embarked upon a sub-manufacturing process through our sister company, Caterpillar of Australia, based in Tullamarine, Victoria. The instructions we received from various Government departments were that we should pursue this rebate. We would suggest a review of this point alone as a basis of improvement in the scheme. (sub. 36, p. 2)

Caterpillar Underground Mining (sub. 36) also called for the TFES to be extended to imports of inputs not manufactured in Australia. The TFES does not pay rebates on goods imported into the mainland of Australia from overseas which have not undergone a manufacturing process on the mainland prior to their shipment to Tasmania.

Empty containers and packaging

It was argued by Fruit Growers Tasmania, the TFGA/TCCI and National Foods (subs. 32, 35 and 37, respectively) that it was inequitable that empty containers and other multi-use packaging such as beer kegs and apple trays shipped across Bass Strait for re-filling were ineligible for southbound assistance, whereas single use packaging materials such as padding and cardboard were. Following the release of the draft report, the Tasmanian Government, Cascade Brewery and the TFGA (subs. DR88, 79 and 73 respectively) reiterated such concerns. In stating its argument, Cascade Brewery suggested that:

> … re-usable/refillable, and used as manufacturing inputs, should be declared eligible under the scheme. These items include beer kegs, vessels and tankers as well as crates and bins used by suppliers to major retailers. None of these items are currently eligible for assistance under TFES, but all are subsidised indirectly by Auslink when transported on major mainland highways. Non-reusable bottles, cartons and cans do receive assistance due to their deemed eligibility under the southbound component of the TFES. Aside from the desire to ensure consistency, there is also an overarching public policy issue involved, namely the desirability of encouraging (or at least not discriminating against) responsible packaging practices and increasing the use of recycled materials by industry. (sub. DR 79, p. 1)

The eligibility of packaging rests on two matters. First, if the packaging forms part of the input to the Tasmanian producer — that is, it is ultimately sold as part of the product it contains, and the packaging becomes the property of the purchaser — then it may be eligible for southbound assistance, but only as part of the good it contains. Second, if items such as bins, crates or boxes are used 'on-site' in the production process in Tasmania (as opposed to solely being used for the freight task itself), then they may constitute 'equipment for use in manufacturing, mining, agriculture, forestry and fishing industries in Tasmania' under clause 4.1(b) of the Ministerial Directions. As such, they would be eligible for southbound assistance. For example, a crate used to contain fruits as they are picked and then sorted before transport may be eligible.

In both of these matters, the distinction as to eligibility for TFES rests on decisions regarding the characterisation of the good in question, and even how particular

claimants use particular containers. As such, eligibility may vary on a case-by-case basis.

Air transport

Air transport is eligible for assistance only in special circumstances, as approved by the Minister or the Secretary, such as when a shipping service is not available due to an industrial dispute, mechanical failure or vessel maintenance (clause 4.2).

Carol Cox said there should be a subsidy for air freight, restricted to fresh perishable produce freighted direct from Flinders Island to Victoria. Exporters of live and fresh chilled seafood mostly use air freight because of the small time window for getting the product to market:

> … fresh seafood must be airfreighted to Victoria from Flinders Island due to the irregularity of any direct shipping service and there only being a once weekly regular shipping service to Bridport in Tasmania to connect via road freight to transport to Victoria. The shelf life of the product, particularly wild fish stock which must be caught when the weather is right, does not allow for the amount of time required to wait for the boat and then two days more to move it to market in Victoria. (sub. DR86, p. 1)

However, in its submission to the Commission's concurrent inquiry into price regulation of airport services, Hobart International Airport said:

> All Tasmanian airports suffer from the competition of subsidised sea passenger and freight transport. These services are real and substantial. Subsidised sea passenger and freight transport adversely affects the revenue of airports and their tenants, particularly the hire car firms and freight companies. For example, Tasmanian salmon producers use both sea and air transport. Our advice is that it costs $2 per case less to transport salmon by road-sea from Hobart to Melbourne, than by air. (sub. 4, p. 6)

There are some commodities which may not need the speed of air, would have used road transport if it existed, and for which regular shipping is too slow. The switch in some air transport to the TT Line is evidence that some cargo did not need the speed benefit of air freight. The Commission does not propose any changes to the current arrangements.

Other matters

- *Southbound trade:* Some participants argued that the southbound TFES should not apply to inputs which are competing with efficient Tasmanian producers of local equivalents (see chapter 4).
- *Anomaly between production livestock and show and race horses:* Roberts Limited (sub. 19, p. 10) claimed there was anomaly in that assistance is only

available for one leg of the journey for stud sheep and cattle, but show and race-horses are eligible for assistance on both legs. They called for eligibility for stud-livestock that are taken to interstate events.

- *Government Business Enterprises:* Government organisations are currently excluded from claiming. Net Sea Freight (sub. 26) noted that since 1998 some Tasmanian Government businesses have been commercialised and are at a competitive disadvantage by the continued exclusion.

FINDING 5.8

The current rules as to which freight is eligible for a rebate result in claims of anomalies in treatment, with ongoing calls for extension of eligibility to other classes of Bass Strait shipments.

5.9 Are the Bass Strait islands well served?

There are two issues of concern with the TFES as it relates to the Bass Strait islands. First, the term 'equalisation' leads to a mistaken belief that the TFES should *equalise* freight costs from any Tasmanian source, for example:

- King Island Regional Development Organisation Inc (sub. 25, p. 1) called for an amended scheme for King and Flinders Island 'to ensure equity with mainland Tasmania in relation to real shipping costs'.
- The Tasmanian Farmers and Graziers Association (King Island Branch) (sub. 40, p. 2) emphasised that the ineligibility of the Devonport–King Island leg was inequitable under a system intended to address cost disadvantages.
- Auspine (sub. 44, p. 2) stated that 'if the scheme is truly an equalisation scheme, we fail to see why … [King and Flinders] Islands should be paying any more than Tasmania for freight to Melbourne'.

The TFES was never intended to exactly equalise net freight costs between the mainland and any Tasmanian source. Even for main island Tasmanians, the proportion of freight costs met by the TFES differs between them. Equalisation is neither the intention nor is it practical.

The second concern of participants is that the absence of a road has a greater impact on the Bass Strait islands, yet the TFES makes no additional provision for these circumstances. Some argued that if the TFES made allowance for a notional land bridge specific to the Bass Strait islands, they would be relatively better off than main island Tasmania when sourcing inputs from the rest of Australia and selling its output. If there were a direct road, King Island would be over 100 kms closer to

Melbourne than would be Devonport producers, but the costs by sea are significantly greater.

A number of participants called for changes that would recognise the greater freight cost disadvantage of the islands. For example, Senator Paul Calvert said:

> … I would support the Commission considering special arrangements for goods despatched from both King and Flinders islands, both in regard to the treatment of empty containers and in regard to consideration about the very high cost of shipping from the Islands to Melbourne … The Bass Strait Islands are widely regarded as a special case, and a variation to the Ministerial Directions under the Scheme would not set a precedent. (sub. 51, p. 3)

Other calls for 'special' recognition of the Bass Strait islands included:

- King Island Council (sub. 6) suggested that containerised diesel fuel for power generation should qualify for TFES. Fuels (and lubricants) are listed as ineligible southbound goods (clause 10.1(b)).
- The Tasmanian Farmers and Graziers Association (King Island Branch) (sub. 40) questioned why Melbourne to King Island via Devonport is currently treated as one leg and attracts TFES but Devonport to King Island does not.

The Tasmanian Government (sub. 52) advised that intra-state cargo remains an issue for the Tasmanian Government and that it currently provides some support to that effect.[5]

To address the greater disadvantage faced by the Bass Strait islands, some participants called for separate scaling factors for each of Flinders Island and King Island. For example, Incitec Pivot (p. 14 in sub. 39 by Michael Ferguson MP) said 'to blanket the whole of Tasmania with two scaling factors [Northern and Southern Tasmania] is assuming that all sea costs are equivalent through all ports'. However, the use of separate scaling factors is problematic. Given the relatively low number of sailings to the Bass Strait islands, discerning the true cost differential to apply would be difficult. Additionally, such a scaling factor would increase payments to all shippers from the Bass Strait islands. A substantial number of claims from the Bass Strait islands fall below the current $855 cap of assistance per TEU, and are therefore not unduly disadvantaged, compared with Tasmanian shippers who pay the same freight rates. As such, across the board increases are not warranted and may lead to overcompensation in some cases.

[5] The Tasmanian Government provides an annual subsidy to Southern Shipping for intrastate freight between the Furneaux group of islands and mainland Tasmania. The freight rate is adjusted annually by the CPI. The subsidy does not apply to King Island.

In contrast, a more targeted approach would be to raise the assistance cap for Bass Strait Island shippers, increasing payments only to those whose freight cost disadvantage is large enough that their assistance level per TEU would otherwise be above the cap. Even this approach is not without problems, as issues surrounding the rationale for providing such assistance to Bass Strait island shippers alone remain.

The Nixon Review responded to calls for separate rules and parameters for King Island (such as a separate road freight equivalent, an increased fixed cost component, separate scaling factors or maximum claim cap) by saying that such changes would amount to a separate freight equalisation scheme for the Bass Strait islands. It further noted that while there were additional freight costs incurred by island shippers, these costs also reflect the choice of producers to take advantage of the benefits that living and producing there offers over locations on the main island.

FINDING 5.9

Some Bass Strait island shippers face particular freight cost disadvantages that are not fully dealt with in the current TFES design.

5.10 Some administration and compliance cost concerns

Administration of the schemes

As noted in chapter 2, the administration of the TFES (as for the TWFS) is undertaken by Centrelink under contract to DOTARS. Few participants commented on this arrangement. G. J. Sales praised the staff of Centrelink and the day-to-day service they provide, noting that they always deal with his inquiries with politeness and a genuine effort to provide assistance (sub. 1, p. 2). However, another suggested that there had been some loss of industry awareness and the ability to identify and investigate non-standard claims. Other participants said that they had few difficulties or complaints with the current administration arrangements.

As reported earlier in this chapter, Warwick Counsell expressed concern about the scope under the TFES for strategic conversion of door-to-door invoices into wharf-to-wharf claims and his perception that DOTARS and Centrelink have failed to deal appropriately with this. He argued that the TFES:

> … needs effective management by a dedicated team, committed to the application of accounting principles and elementary rules of compliance [and that] … neither the

> Department of Transport and Regional Services nor Centrelink are competent to manage the TFES. (sub. 18, pp. 1, 5)

He proposed that the management and administration team should be located in Tasmania and be part of the Treasury portfolio.

The TFES database

One of the Commission's concerns about the administration of the scheme involves the supporting database. It is large and complex and data extraction is not straightforward. The Commission has been critical, in several places in this report, as to how the operation of the TFES leads to overestimation of some costs. This makes it more difficult to rely on the database when evaluating the TFES. For example, to the extent that any of the adjustment parameters are derived from the TFES database, there is a risk of a 'feedback loop', whereby distorted data on freight tasks can affect future calculations. The Commission found that it had to spend considerable time calculating summary information from the database in order to help evaluate the TFES.

In particular, it appears that not all data relevant to a claim (and present on the TFES claim form) is recorded by Centrelink. For example, both tonnes and containers are used to measure the amount of product transported. However, it is not uncommon for the database to only record one of these variables for a particular claim, not both. Such omissions hamper analysis of the database and review of claims.

Improvements could also be made in the use of the existing information in the database. To assist in future reviews, and ongoing audit, the database software should automatically flag variations in claims from established benchmarks (for example, the average freight rate for that particular commodity or route). Automating such a process would assist in the identification of particular claims for investigation, and as such improve the use of resources for auditing claims.

Additionally, further information could be provided to improve the database. Under the current scheme, an invoice recorded in the database as wharf-to-wharf can be either an actual wharf-to-wharf invoice or a component of a door-to-door invoice. The amount of such an invoice can be determined by documentation provided by either a carrier, a freight forwarder or a northbound broker. For the purposes of analysis of the claims, the database should record the exact nature of the wharf-to-wharf invoice, including the source of the documentation.

Transparency

The Maritime Union of Australia said there is insufficient publication of scheme statistics and recipients:

> While we are grateful to Centrelink for providing annual statistics, there are weaknesses in the data set made available by Centrelink. First, there is no year on year or trend data on key variables such as freight shipped under the TFES. Secondly, there is insufficient data on the firms who are accessing the scheme. We believe that as well as a top 10 commodity indicator, there should be a top 20 (or so) firm or business user indicator. We would also wish to see the relationship of employment to firms accessing the scheme so an analysis can be made of the employment linkages to the scheme beneficiaries. That is, we believe the top 20 (or so) user firms should provide employment data, and such data should be publicly available. We would also wish to see indicators that provide an overview of the significance of the TFES to the Tasmanian economy. As most of this data is already collected, or available, we believe it should be published in the interests of transparency. Transparency in our view is an important feature of accountability, and accountability is required to maintain public confidence … [in] the use of targeted Government assistance programs such as the TFES. (sub. 59, pp. 11–12)

The Commission strongly agrees that greater transparency is needed. Many Australian Government programs, including the Regional Assistance Program (which is also under the responsibility of DOTARS), publish such details as the identity of recipients and amounts paid. This should also be the practice for the TFES. A greater range of information from administrative records should be regularly calculated and published to promote greater transparency and accountability.

Parameter reviews

As noted earlier in this report, several reviews of the TFES parameters have been undertaken, but the recommendations were not implemented and the results were not publicly released. Indeed, many participants who called for changes to parameters were unaware that such reviews had taken place.

DOTARS explained the outcome of these reviews:[6]

> In recommending adjustments to the key parameters, each of the reviews pointed to significant estimation and data problems that constrained confidence in the findings. It

[6] The first of these was conducted by the BIE in 1998-99, followed by the CIE in 1999-2000. The three subsequent reviews covering 2000-01, 2001-02 and 2002-03 were conducted by the BTRE. The most recent review (2002-03) was finalised in October 2004 (table 2.3). The BTRE has been requested to undertake a review of the 2005-06 parameters. The report is expected to be finalised by December 2006 (DOTARS, sub. 53).

> was of particular concern that the recommended adjustments to the key parameters flowing from the analysis would have been expected to redistribute assistance among recipients, while their impact on overall programme expenditure would have been minor. As a consequence, the 1996-97 values have continued to be used in each year since the inception of the current Scheme. (sub. 53, p. 10)

As reported in chapter 2, DOTARS advised that the parameters had not been changed because the estimated changes were considered not to be material. Net Sea Freight (sub. 26) argued that annual reviews and annual indexation are not essential, as frequent changes could cause confusion and uncertainty. It suggested that a three year interval between reviews and possible parameter changes would be preferable. Norske Skog said that key parameters need to be regularly reviewed, but annual reviews would be time consuming and expensive (sub. 24, p. 25). The TFGA/TCCI called for rolling five year funding programs supported by a transparent framework for adjusting parameters. It said there was a need to:

> … identify and explain the methodology to be employed in adjusting the parameters, the supporting data requirements and how they might be collected, and determine the annual date on which the adjustment would be implemented. (sub. 35, p. 6)

The Commission concludes that rigorous parameter reviews should be conducted every three years and released upon completion.

Compliance costs

Views on the costs and difficulty of complying with the subsidy schemes were also mixed. Some of the larger shippers have systems in place to facilitate claims, but in other cases firms faced higher costs in preparing claims. Compliance costs are generally not a major concern, at least for large claimants and northbound shipments.

For example, Norske Skog said its claims are straightforward to prepare because its business systems generate the required information and there is consistency in the tonnages and destinations of its shipments. It estimated that monthly claims take six hours. The ability to submit a bulk claim minimises administration costs to all parties (sub. 24). Similarly, Auspine said that it has applied considerable time and cost to develop an inventory management system to efficiently and accurately handle TFES claims (sub. 44, p. 3).

Cascade Brewery observed that, while the administrative aspect of the scheme, whereby original documentation is required, can be quite cumbersome and time consuming:

> … for a large recipient of subsidies it is not unmanageable or grossly inefficient. Large claimants have been able to automate parts of the administrative process that improves the efficiency of making claims. The TFES is well established and the rules well known within industries that utilise and benefit from the scheme and there is little uncertainty. Whilst there is certainly complexity in some of the formulae used to calculate subsidies, this is easily managed with spreadsheet programs ... (sub. 4, p. 3)

It also noted that:

> The administrative cost of the … [TFES] … totals less than 2% of the total rebates received. In the past 5-10 years administrative and procedural changes made by our firm and the administrators of the scheme (Centrelink) have resulted in improvements to the process and reduced labour hours required to comply with requirements and complete claims. (sub. 4, p. 2)

G.J. Sales said that it found the current system for claiming 'transparent and simple to work alongside', and that:

> It would be fair to say that a majority of claims are generally repeated cargo flows and once understood and verified become the task that most clerks could administer, and still be sure that their company's claims are appropriate. (sub. 1, p. 2)

However, southbound claims appear more complex and costly — in part because of the prevalence of less than full container load shipments and the need to demonstrate that the goods will be used in a production process. This may be deterring some producers from being involved. Roberts Limited said that, in the context of southbound grain, the TFES is complex to administer.

> There are onerous obligations for collecting data, duplication of paperwork, and administrative on-costs that absorb clerical effort. There needs to be an emphasis on simplifying the processes to reduce the administrative liability of the TFES. (sub. 19, p. 7)

Compliance costs could possibly be reduced with greater electronic claims lodgement. The TFGA/TCCI said it would welcome such a system (sub. 35, p. 31). However, one guiding principle should be to avoid making changes that reduce compliance costs but add to administration costs (or vice versa).

Simplification by changing the form of assistance to a single flat rate rebate per TEU would reduce compliance costs for claimants and administration costs for Centrelink. The TFGA/TCCI gave partial support to this approach:

> … there may be scope for some limited application of a flat rate assistance approach as a supplementary alternative for those shippers who find the current approach administratively onerous. This should only be an alternative for claimants to consider at their discretion. (sub. 35, p. 6)

FINDING 5.10

Administration of the TFES could be improved by:

- *publishing more comprehensive data that is better aligned with the requirements of external analyses of the scheme;*
- *publicly reporting annual payments made to recipient companies;*
- *reducing compliance costs via electronic lodgment; and*
- *publicly releasing parameter reviews as they are completed.*

5.11 The Tasmanian Wheat Freight Scheme

Tasmania is a net importer of grain. Of an estimated 130 000–150 000 tonnes of grain consumed in Tasmania each year, only about 40 000–50 000 tonnes is produced in that state. In drought years, an additional 40 000 tonnes of grain has been brought from the mainland to cover the reduction in local harvest and for supplementary feeding of livestock.

As summarised by the Department of Transport and Regional Services (sub. 53, appendix 3), the forerunner of the TWFS dates from 1989 when the Australian Government deregulated the domestic wheat marketing and pricing arrangements. Prior to deregulation, shipments of wheat to Tasmania were subsidised as part of the arrangements for a common 'home consumption price' throughout Australia. The subsidy had been financed by a wheat industry levy under the succession of wheat industry marketing plans that had applied since 1953.

With deregulation, the Australian Government introduced the Tasmanian Wheat Freight Subsidy Scheme to provide transitional support to the wheat-using industries in Tasmania while they adjusted to the new wheat marketing arrangements. The special purpose payment was available to shippers to subsidise the transport of wheat to Tasmania. The scheme was subsequently extended twice and terminated in June 2004. It had been subject to a budget cap, paid subsidies on a per tonne basis, and covered all uses of wheat and forms of shipment — non-bulk as well as bulk.

With the ending of the Tasmanian Wheat Freight Subsidy Scheme, more wheat shippers began using containerised shipments and obtaining transport subsidies from the TFES (chapter 2, table 2.4). This resulted in wheat being treated on the same basis as other grains. There had been no subsidies for the bulk shipment of other grains and shippers of them already obtained freight subsidies from the TFES for non-bulk shipments.

In August 2004, the Australian Government introduced a revised scheme for bulk wheat shipments — the current TWFS — and made its coverage retrospective to 1 July 2004. It capped the expenditure at $1.05 million a year and provided for subsidies of up to $20.65 per tonne (see chapter 2). Notwithstanding the reintroduction of subsidies for bulk shipment, use of the TWFS has declined and no shipments or claims were made in 2005-06. (At the draft report hearing, Monds and Affleck, a subsidiary of Roberts Limited, said that it was expecting a bulk shipment to arrive during 2006-07.) Wheat shippers have switched to using containers and obtaining subsidies from the TFES. Some argued that the use of containers offered benefits in the distribution of wheat in Tasmania.

For example, Rural Logic said that it did not prefer the option of mini-bulk vessels in supplying grain to Tasmania because of:

> a. The lack of available independent bulk silo space in Tasmania.
>
> b. The task of assembling a grain cargo (approx 7000 tonne) and guaranteeing that it will be free of prohibited weed seeds is not without a high level of risk, especially for on farm distribution.
>
> c. Containers offer the supplier and customer an economic grain parcel without the risk of a large tonnage being stored in Tasmania.
>
> d. The consolidation of grain stock at one location in Tasmania, plus double handling and sideways transport costs result in similar cost when compared with container movements. In fact, the all up costs of using a bulk vessel via Portland to Tasmania for grain including port handling charges would total $96.00 per tonne. (Rural Logic, sub. DR84, p. 4)

While factors such as convenience, delivery point and availability of storage also influence the choice of sea transport mode, an important driver of the switch from bulk to containerised shipments has been the additional assistance available under the TFES compared with the TWFS. In 2004-05, bulk shipments halved, notwithstanding bulk shippers receiving the maximum subsidy of $20.65 per tonne (chapter 2, table 2.4). Containerised shipments increased three fold and received a rebate of $29 per tonne on average for 2005-06.[7]

[7] Kelly and Sons (sub. 30), a private grain trading and storage company based in southern NSW, identified elements of natural monopoly associated with the bulk shipment of grains to Tasmania and strongly supported continued transport assistance for containerised wheat under the TFES because of the competitive discipline it provided to the operators of bulk grain handling and maritime freight services provided to Tasmania. It also canvassed the extension of the TWFS to other grains on grounds of providing a competitive discipline to Bass Strait container freight operators.

Roberts Limited reported that 'due to the added benefit derived from the TFES, almost all grain imported into Tasmania is [now] transported in containers'. It submitted that, in respect of its own operations:

> Despite the added costs of filling and decanting containerized freight, it attracts a Tasmanian Freight Equalisation Subsidy of approximately $34 per tonne. After subsidies are paid, containerized freight is approximately $15 per tonne less than bulk cargo. (sub. 19, p. 5)

An impact of the switch to containerisation for wheat is the significant surplus capacity that has arisen in bulk grain handling facilities. Monds and Affleck said that the switch to containerised wheat had 'significant infrastructure ramifications':

> There's potential to lose the access to bulk shipping and future investment and facilities and also the impact that would have on the grain reserves, … such as a drought year as we have this year. (trans., p. 86)

Roberts Limited (sub. 19, p. 6) said that this may have adverse implications for the Feed-Grain Emergency Management System.[8] However, it is not clear why containerised shipment of grain cannot handle such emergencies.

An important issue for this review is whether the structure of subsidies under the TFES and TWFS for wheat and other grains has adversely distorted resource allocation efficiency through influencing the choice of mode of freight transport. Based on previous CIE analysis (2001) and the size of the subsidies involved, it would appear likely that in the absence of TFES and TWFS there would be more bulk shipment of both wheat and other grains.

FINDING 5.11

The Tasmanian Wheat Freight Scheme singles out the transport of wheat to Tasmania from all other bulk cargoes for subsidisation. The original purpose for such selective treatment — facilitating adjustment in Tasmania to a competitive domestic wheat market — has been fulfilled.

FINDING 5.12

The current interaction between the TFES and the TWFS has distorted the efficient pattern of wheat transport. The TWFS was unused in 2005-06.

[8] Roberts Limited said that 'Along with other industry partners, Tasmanian Grain Elevators is responsible under Tasmanian Government regulations, for managing the logistics of a strategic feed-grain reserve as part of the Feed-Grain Emergency Management System for use in times of drought and extreme hard-ship. Ongoing use of containers, away from stored bulk imports, places in question the long-term viability of the capital infrastructure at Devonport including the silos and handling equipment' (sub. 19, p. 6).

6 Rationales for the schemes

This chapter assesses the key arguments for subsidising the sea freight costs of Tasmanian goods that are shipped to the mainland and of selected Australian-produced inputs shipped from the mainland. It examines arguments put forward by participants, objectives that may be inferred from the design of the schemes, and the views contained in previous reviews of the TFES.

The TFES has been a feature of the Tasmanian business environment since the mid-1970s, and there have been arrangements for subsidising the cost of shipping wheat from the mainland to Tasmania since the 1950s. This chapter looks at the rationales for such schemes.

6.1 Rationales for subsidising Tasmanian sea freight

Paragraph 4 of the terms of reference requires the Commission to 'provide recommendations on an appropriate future approach and/or arrangements' for the subsidisation of containerised and bulk shipping between the mainland and Tasmania. An important prerequisite for the evaluation of a program, and of the scope to improve its effectiveness, is a sound understanding of its underlying rationale. But as noted in chapter 1, there has been long-standing concern about the underlying objectives of the TFES.

Many participants relied upon the description of the role of TFES by its administering department, DOTARS, to the effect that the scheme:

> … assists in alleviating the comparative interstate freight cost disadvantage incurred by shippers of eligible non-bulk goods carried between Tasmania and the mainland. Its objective is to provide Tasmanian industries with equal opportunities to compete in mainland markets, recognising that, unlike their mainland counterparts, Tasmanian shippers do not have the option of transporting goods interstate by road or rail. (DOTARS website)

Indeed, a common view among participants was that the TFES is simply a scheme that:

> … addresses a specific objective, 'the reduction of the sea freight cost disadvantage' … (Australian Paper, sub. DR89, p. 3)

The Tasmanian Chamber of Commerce and Industry saw the rationale for both schemes as equitable treatment of Tasmanian industry in respect of interstate trade and specifically, access to production inputs and to markets for their goods:

> To achieve this, neutrality in terms of access to transport infrastructure is essential. … The Australian Government has been actively engaged in pursuing this equity between mainland states on a number of fronts. These include identification and improvement of national highway infrastructure and the removal of barriers to trade such as the conflicts in rail gauge that existed at the time of federation. In Tasmania's case, the barrier to trade is Bass Strait and without the equity provided through TFES and TWFS, access to Tasmanian markets by mainland producers and the reciprocal access to mainland markets by Tasmanian producers would be severely compromised. (sub. DR74, p. 2)

The Treasurer of Tasmania emphasised the role of state equity arguments, arguing that the principles of federation are critical to any assessment:

> The principle of resource sharing, based on the principles and practices of federation, justifies the need for the Tasmanian Freight Equalisation Scheme to overcome the absence of land transport across Bass Strait. (trans., p. 67)

And as noted earlier, the Prime Minister referred to it as:

> … an important element of Australian government programmes that equalise cost disadvantages between the States and Territories. (Howard 2006)

Indeed, many participants argued for maintenance of the current scheme, or changes to it, on the basis of evidence as to the nature and quantum of freight costs they incur compared to shippers on the mainland. But such claims are difficult to assess without a clear view as to the underlying objectives that freight subsidies are intended to serve. Several participants provided their views (box 6.1), while previous reports on the TFES have also commented on this matter (chapter 1). Drawing this material together suggest four main rationales for freight subsidies, namely, that:

- 'equalisation' payments are an entitlement that is justified by the higher costs to Tasmanian producers of shipping their products across Bass Strait;
- Tasmania is entitled to federal transport funding, albeit in a modified form, for its interstate transport link across Bass Strait;
- 'compensation' should be payable for the additional costs that arise from government policies in respect of coastal shipping, road and rail transport; and
- economic development and employment growth in Tasmania warrant special support.

Box 6.1 **Selected participants' views on rationales for freight subsidies**

Net Sea Freight suggested there were six economic and social rationales for freight subsidies, namely:

- *a constitutional basis*, whereby a political decision has been made to ensure that Tasmanian firms do not suffer a cost disadvantage due to Bass Strait;
- *an economic case*, arising from the need to use higher cost sea transport and an inability to use road or rail transport;
- *a compensation case*, based on the likelihood that government-imposed limits on the operation of foreign vessels impose disproportionate costs on Tasmanian shippers;
- *a social case*, that some smaller towns are largely dependent upon economic activities whose output is subject to freight assistance;
- *economic and social synergies*, when some such communities may be capable of functioning with a modest level of support and where, in some cases, assistance under the TFES is all that keeps a particular activity economic; and
- *a second best argument*, which notes that constraints such as land transport not bearing its full cost, cabotage, and restrictions on imports of ships mean that providing assistance, even if distortionary, will not necessarily lead to less efficient outcomes. (sub. 26, sect. 4)

Other participants suggested a similar broad range of rationales:

> … the intent of the scheme (to alleviate the comparative interstate freight cost disadvantage incurred by shippers of eligible non-bulk goods carried between Tasmania and the mainland) is valuable and necessary for the Tasmanian Agricultural sector. (Agricultural Contractors of Tasmania, sub. 8, p. 1)
>
> The purpose of the [TFES] is to ensure that manufacturers and producers in Tasmania are not disadvantaged by the extra cost of moving freight across Bass Strait in relation to moving freight on the National Highways over the same distance. (Tasmanian Transport Association, sub. 5, p. 1)
>
> The [TFES] was instituted as a tool of economic development in response to the underlying trade barrier that Bass Strait presents. The rationale for its existence is the requirement that all Australian States be treated equitably with respect to accessing the benefits of interstate trade. To do so, States require comparable and cost equivalent access to transport infrastructure. This rationale remains as pertinent today as ever. (Australian Paper, sub. 34, p. 2)
>
> As stated in 1976, the Commonwealth Government's objective was to establish a cost equalisation scheme to alleviate the freight cost disadvantage incurred by shippers … As the freight cost disadvantage has widened since that time, the rationale for the equalisation scheme is even more relevant today. (National Foods, sub. 37, p. 2)
>
> … the scheme is aimed at allowing Tasmanian companies [to] compete on a level freight playing field with mainland producers. … The aim of the southbound Freight Equalisation scheme is to lower the cost of imported components in Tasmanian manufacturing, processing and agriculture. (Cement Australia, sub. 23, p. 1)

The following examination of each of the proposed underlying objectives draws on the analysis and evaluation of the designs of the schemes that was contained in the preceding chapters, the level and distribution of payments, and their economic effects.

To compensate Tasmanian producers for higher transport costs?

Participants provided the Commission with considerable evidence as to the range of freight cost disadvantages that Tasmanian firms suffer in seeking to compete for sales in the key mainland domestic markets, compared with producers that are more advantageously located. Their particular freight cost disadvantages arise from the need to ship produce across Bass Strait, and the need to transfer virtually all interstate shipments from road or rail to ships and back again, with all of the concomitant intermodal costs and additional specific costs that arise from the nature of sea transport itself. (A more detailed discussion is contained in chapter 3, which also notes some of Tasmania's competitive advantages.)

Producers in many other regional areas of Australia also face higher costs and a wide range of transport-related difficulties, including poor or seasonal roads, long distances and irregular services in getting their produce to the main markets. If reducing freight costs is the underlying policy rationale, it would be expected that similar schemes would be in operation elsewhere in Australia. However, producers in such regions rarely benefit from explicit government freight subsidies.

More broadly, all regions have their own mix of cost and other advantages and disadvantages in respect of production and distribution, whether they be the price and fertility of the land, the climate, local labour markets, the quality of local infrastructure, closeness to markets and so on. This pattern of advantages and disadvantages alters over time, including in response to changing costs.

In some circumstances, a disadvantage associated with location, such as relatively high transport costs, may be at least partly offset by an advantage, also related to location, such as the quality of the product or the ability to service a market outside of the main season. In essence, locational cost differences are a major influence on the most economical pattern of production for Australia as a whole.

The importance of freight costs also differs between firms — in Tasmania as elsewhere. In part, it depends on the nature of the product. Some producers require specialist and costly packaging or shipping arrangements for the sea voyage. In addition, those Tasmanian producers located close to ports and to frequent and reliable shipping services are at an advantage compared to producers in more

remote locations, including on the Bass Strait islands where transport links are tenuous.

On the other hand, for sales within the Tasmanian market, isolation provides local producers with a degree of competitive advantage against mainland producers. However, in the case of local producers of inputs and raw materials, this natural advantage is reduced by the availability of (southbound) TFES subsidies on competing goods from the mainland.

The Commission's assessment of the data available to it and the arguments contained in submissions is that there is little justification for government to provide a transport subsidy on the grounds that the costs for one particular region are higher than for producers in other regions. Transport is but one of the factors of production and distribution that all firms across Australia must take into account when determining whether production in a particular region would be viable.

Moreover, it is also difficult to reconcile such a rationale with the current scope of the TFES. A scheme intended to alleviate freight costs would in principle apply to a broad range of goods transported in either direction across Bass Strait. But as noted in chapter 2, this is not the case under the TFES. The Commission does not accept that the locational disadvantage that Tasmania faces provides a sufficient case for subsidising Bass Strait sea freight costs.

Intervention by government can do no more than transfer resources to support one region at the expense of all other regions. Indeed, as demonstrated in chapter 4, there is a small net cost to the country as a whole when all factors, including the costs of raising the revenue, are taken into account.

To support interstate transport links?

Tasmania's freight (and passenger vehicle) subsidies are seen by some as a de facto entitlement justified by the state's inability to share fully in federal funding of interstate transport infrastructure — for example, under AusLink.[1]

Peter Brohier has argued that, while AusLink is intended to deliver an integrated, national transport network by investing in significant road and rail infrastructure over major national arteries, including between capital cities:

> … [the] only significant gap is the nation's only interstate ferry system or sea-link crossing Bass Strait. If Auslink expenditure is justified between all mainland capital

[1] AusLink is the Australian Government's program for developing national land transport infrastructure. It sets priorities for investment in road and rail infrastructure links that are judged to be of national importance, including intermodal transfer facilities (http://www.auslink.gov.au).

> cities then, why not Melbourne to Hobart, the Nation's shortest inter-capital route? If rail infrastructure is to be incorporated, so can ferries. The ferry infrastructure and some parts of its operation could easily deliver an Auslink connection. Auslink can't be described as 'integrated' and 'national' without this link. (sub. 2, p. 1)

He argued that this would provide particular benefits to both Tasmania and Victoria. Implementation would involve adjustment of the TFES (and the Bass Strait Passenger Vehicle Equalisation scheme) to provide:

> … comprehensive transport equalisation to align basic transport costs by sea, for non-bulk freight, vehicles and people crossing Bass Strait to the cost of travelling on a highway or other inter-capital Auslink corridor. (sub. 2, p. 1)

The Victorian Government also saw an overlap between AusLink objectives and those being pursued by the Tasmanian freight schemes. It saw scope for pursuing national transport objectives by 'encouraging improved freight transport connectivity':

> The Victorian Government suggests that the most effective and equitable way to align the TFES and AusLink policies would be to extend the subsidy to final goods in the southbound direction. (sub. 60, p. iv)

AusLink funding already directly benefits Tasmania, principally for the Hobart to Burnie land transport corridor. Tasmania also benefits indirectly from AusLink developments that improve the operation of Australian ports and intermodal links that are used, whether directly or indirectly, by Bass Strait trade.

However, AusLink is primarily concerned with investment in transport *infrastructure*, rather than with the subsidisation of transport *services* that use the infrastructure. Even if it was determined that transport services fall within the ambit of AusLink, claims for funding of transport subsidies would need to be considered and prioritised against competing claims for AusLink funding. In particular, it would need to be demonstrated that there would be net benefits to the Australian community as a whole from providing such a service to Tasmania and that it constituted a stronger claim for funding than competing projects elsewhere in Australia.

The adoption of subsidy arrangements on grounds of funding a notional 'land bridge' would significantly widen the scope, scale and cost of the current subsidy. In contrast to the current discriminatory TFES arrangements, it would involve paying assistance to all freight (and passengers) transported in either direction that would otherwise go by road or rail. The end use of goods shipped would no longer be a consideration (although expansion of the TFES to explicitly take exports into account could raise WTO issues). The distribution of payments would change considerably. If there were to be budget neutrality, this would imply a much lower

payment per claim. Alternatively, there would need to be a substantial increase in Australian Government funding.

To compensate for other government policies?

As noted in chapter 1, the Inter-State Commission (ISC), in a major review in 1985, found no satisfactory reasons, based on economic efficiency, to support subsidies to 'equalise' Bass Strait freight costs with mainland freight costs. But it did see a case for subsidies to be paid to Tasmanian shippers to offset the adverse effects on them of government transport policy decisions that kept the costs of coastal shipping higher than they otherwise would be (ISC 1985, p. 68). Indeed, the ISC recommended that the TFES be configured explicitly as a *compensation*, rather than an *equalisation*, scheme.

The ISC said that these policies had a disproportionate effect on the cost of shipping across Bass Strait, in an environment where Tasmanian shippers were unable to take advantage of the subsidised road and rail transport services available on mainland interstate routes. In its view:

> … economic inefficiency is created by government policies which raise freight rates for coastal shipping without subjecting the other transport modes to regulation which affects their freight rates in a similar manner. … Those who ship goods to and from Tasmania are the only ones who cannot avoid the effects of higher coastal sea freight rates because they cannot take advantage to the same extent of subsidised land transport using road or rail. (ISC 1985, p. 81)

Australian Paper argued that successive governments have entrenched practices that:

> … impose a disproportionate cost on the transport of goods across Bass Strait when compared with similar movements on the mainland. (sub. DR89, p. 2)

It noted that gains have been made in such areas as improved land transport infrastructure and national standards for vehicle operations, while high operating cost structures have been perpetuated in Australian coastal shipping (sub. DR89, pp. 2–3).

Tasmanian shippers are not alone in being disadvantaged by the higher cost of coastal shipping. To the extent that coastal shipping costs are higher because of government policies, all users of coastal sea freight services could mount a case to receive compensation.

Although cabotage and coastal shipping policies continue to hold shipping costs higher than otherwise, the extent of the disadvantage has been reduced since the 1970s when the TFES was introduced. Reforms have encouraged smaller crew

sizes, investment in more modern vessels and greater flexibility in work practices. Single and continuous voyage permits are now available to ameliorate the adverse effects of current arrangements in prescribed circumstances, but these are unavailable on the Bass Strait route. Notwithstanding these reforms, there remains scope for further gains to all users from improving the performance of coastal shipping (PC 2005b, pp. 220–2).

In relation to the impact of government policies on road and rail freight costs, and notwithstanding the changes that have occurred in recent years, some argue that cost recovery charges for some heavy road vehicles do not fully cover the associated wear and tear on road infrastructure and this, in turn, depresses prices for competing rail freight services (PC 2005b, pp. 214–16). Any such cost under-recovery would be exacerbating the disadvantage facing Tasmanian firms that use shipping services for part of their freight task, relative to those that use road transport.

While the level of cost recovery by trucks and rail remains uncertain, the most efficient and effective approach to these matters is to continue to directly address those policies that create the distortions. This is consistent with the program of reform of regulatory, institutional and funding frameworks adopted by all governments under the National Competition Policy and the National Reform Agenda.

In view of uncertainties about charges for transport infrastructure, and the adverse impacts of inefficient charging, further investigation of the broader impacts of government transport policy is warranted. At the request of the Council of Australian Governments (COAG), the Commission is currently undertaking a separate public inquiry into the economic costs of road and rail freight infrastructure, including efficient approaches to pricing. This inquiry will report at the end of 2006. And, in its recent report on national competition policy reforms, the Commission recommended a review into the requirements for an efficient and sustainable national freight transport system, encompassing all freight transport modes, including coastal shipping (PC 2005b, pp. 220–2).

To support economic development and employment in Tasmania?

Over the years, governments have implemented a range of programs designed to promote investment and growth in regional areas. The programs have been very diverse — for example, some have been generally available to businesses in regional Australia, some have been specific to designated areas, some have been targeted at particular activities and others at specific business costs (such as freight costs under the TFES).

While having a common objective of promoting regional development, the rationales of these programs have varied markedly. For example, some have addressed perceived 'market failures' (such as firms having insufficient information about the benefits of establishing in regional areas) and some have been justified on social or equity grounds (such as helping to overcome disparities in the capacity of governments to provide equal standards of services).

Examples of some Australian Government programs that affect Tasmania are given in box 6.2. In comparison with the TFES, which is funded annually and is uncapped, they are typically focused on a single industry or region, and may be payable on a 'one-off' basis. Consequently, their impacts are somewhat more targeted than are those of the TFES.

In terms of promoting regional development, government support for shipping services is not uncommon – the issue is whether it is well targeted and cost-effective. The Tasmanian Government supports transport and tourism through its ownership and subsidisation of the T-T Line, which carries passengers and their vehicles and freight. Scotland provides subsidies to passenger and vehicle ferry services to the Orkney and Shetland Islands (by way of a tender process). In Australia, the South Australian Government had provided shipping freight subsidies to Kangaroo Island producers, but has subsequently replaced them with an economic development package for the island.

The form of assistance provided by the TFES — a subsidy for one cost component of designated goods entering interstate trade — does not conform with other programs designed to promote regional development. Such programs are typically targeted at a specific industry or region. Nevertheless, the TFES as it is currently configured can be seen as having some role in assisting the economic development of Tasmania as a small island state. Simplot observed that the TFES 'is not so much about freight as it is about the viability of the Tasmanian economy', adding that:

> The TFES scheme is critical to leveling the playing field between States, and is critical to ensuring an equitable competitive platform for Tasmanian manufacturers. (sub. DR82, p. 2)

Similarly, Australian Paper said that, while the TFES was instituted as 'a tool of economic development' in response to the trade barrier posed by Bass Strait:

> The rationale for its existence is the requirement that all Australian States be treated equitably with respect to accessing the benefits of interstate trade. To do so, States require comparable and cost equivalent access to transport infrastructure. (sub. DR89, p. 2)

The Tasmanian Chamber of Commerce and Industry said that the TFES was established:

> … as a tool of economic development in response to the underlying trade barrier that Bass Strait presents. (sub. DR74, p. 2)

But it qualified this by adding that the TFES 'is not a regional development or assistance initiative':

> It is an equity measure to ensure that one state of the federation is able to compete with other states and is not disadvantaged because it is an island. Without the TFES, Tasmanian industry and businesses could not compete with other states. (sub. DR74, p. 3)

Box 6.2 Regional and other government assistance: Tasmania

The *Tasmanian Country Sawmills Assistance Programme* is a $250 million joint commitment of the Australian and Tasmanian governments, announced on 13 May 2005, to revitalise the Tasmanian timber industry and preserve old-growth forests.

The Tasmanian fishing industry can apply for assistance under the *Securing our Fishing Future* package, a $220 million commitment announced on 24 November 2005, to facilitate adjustment to Government measures to limit catches for sustainability reasons. Almost $150 million will be exit assistance, another $30 million for onshore assistance for business affected and $20 million to go towards assisting affected communities.

The Cradle Coast region of Tasmania is one that has been targeted under the Australian Government's *Sustainable Regions Program*. To date, over $12 million has been awarded for a range of community and business initiatives. The average grant has been more than $320 000, with three over $1 million. Some of the successful applicants also receive TFES.

The Australian Government announced on 24 May 2006 that it will contribute $2.1 million towards construction of the Warner Creek Dam on Tasmania's Meander River (Abetz and Barnett 2006). This will provide a reliable water supply for irrigated agriculture, lead to significant economic growth for the region, and create more than 170 new full-time jobs in the local community during the construction stage.

On 29 May 2006, the Australian Government announced an $8 million Beaconsfield Community Fund to 'support a range of community-led economic, social and culturally related projects in Beaconsfield so that the community can grow and prosper'.

Seven Tasmanian food processing businesses have been awarded almost $0.7 million from the first three rounds of the Australian Government's *Food Processing in Regional Australia Program*. Some of the successful applicants also receive TFES.

The Australian Government's *Regional Partnerships' Program* has funded a number of community projects in Tasmanian regions where TFES recipients are located.

The Tasmanian Government saw the provision of freight assistance as consistent with many other examples of Commonwealth funding to assist the economic

development of disadvantaged regions of Australia. It cited examples such as the building of the Ord River dam and the provision of beef cattle roads in Queensland and Western Australia, and more recently the Adelaide to Darwin railway. It added that:

> The principle of sharing of resources amongst States continues today. It underpins the notion of horizontal fiscal equalisation, where the Australian Government, through the Commonwealth Grants Commission, distributes revenue in a manner that ensures all Australian citizens have access to equal standards of government services. (sub. DR88, p. 2)

However, if economic or regional development is the Australian Government's underlying objective, freight subsidies are not the most cost-effective means of delivery. The subsidies are not equitable within Tasmania. The TFES discriminates against industries that are ineligible for payments under the Ministerial Directions, and favours transport-intensive industries and methods of production. A program more directly targeted at regional assistance would be more beneficial to Tasmania. It would be less discriminatory and create fewer distortions, and the benefits would accrue more widely.

6.2 The Commission's assessment

The TFES involves an expenditure of $92 million of public funds, and raising those funds and administering the programs involves further costs. As the Secretary of the Treasury emphasised recently, all activities that command additional resources in an economy that is close to full capacity utilisation without at the same time expanding supply must impose a cost on somebody.

> … almost every day I hear somebody arguing that some activity should be accorded a special taxpayer-funded hand-out, either because it will 'create' some impressive number of new jobs or because, if it doesn't receive taxpayer-funded support, an equally impressive number of jobs will be 'destroyed'. These arguments must be based on a view that the economy is in a state of chronic under-utilisation of labour and that the central task of government is to provide taxpayer-funded subsidies to those who have sufficient wit to find ways of employing people. Well, that view is at odds with what we observe in the Australian economy of today … (Henry 2006, p. 3)

He added that, if growing businesses are not being subsidised, any reallocation of labour in their favour increases GDP, but where they are being subsidised, or if governments step in to prevent other businesses from shrinking, then GDP is lowered (Henry 2006, p. 3). This view is consistent with the modelling reported in chapter 4.

As noted in chapter 4, evidence provided by many TFES recipients indicates that they have established or expanded in Tasmania in the expectation that a proportion of their operating costs will continue to be funded by taxpayers. But it is because expenditure on freight subsidies competes against other fiscal priorities that it should efficiently and effectively address clear and sound objectives. However, while the Commission is fully aware of the operational objectives of the TFES and the TWFS, and notes the Government's continuing support for them, it remains concerned about the lack of an unequivocal underlying economic rationale for either. None of the objectives put forward are without problems and none of the arguments for freight subsidies are compelling. As a result, it is difficult to draw meaningful conclusions about the appropriate scope of the scheme. However, as the Government has announced that the scheme will remain, the Commission has taken its scope as a 'given' and focused on ways to make the arrangements operate more efficiently and effectively.

FINDING 6.1

While the operational objective for the TFES is to alleviate individual shippers' sea freight cost disadvantages relative to a road freight equivalent, there is no sound underlying economic rationale for freight assistance.

FINDING 6.2

If addressing Tasmania's disadvantage as a small regional economy is seen as the appropriate rationale, a more targeted regional development program, rather than freight subsidies, would be a more cost-effective means of delivery.

7 Alternatives to current arrangements

The mechanism for making payments to claimants should be changed. This chapter examines different approaches that would reduce the complexity of the scheme, the 'gaming' of the scheme and the costs of its administration. It also proposes changes to the TWFS.

The current TFES relies upon set parameters in an effort to reduce complexity and administrative costs. Nevertheless, considerable complexity remains, and the simplifying parameters have themselves created incentives that compromise the integrity of the scheme in achieving its operational objective. The structure facilitates gaming and can lead to overcompensation of wharf-to-wharf freight cost disadvantage. Adjusting the parameter values will not overcome these inherent problems. A change in approach is needed.

Responses to the draft report confirmed the existence of these problems. For example, the Major Tasmanian Manufacturers said that:

> The Productivity Commission's concerns regarding potential for 'rorting' as a consequence of fraudulent claims is acknowledged. Similarly the potential for maximisation of assistance through claiming on a door-to-door basis and similar rule workarounds which are outside the spirit of the Tasmanian Freight Equalisation Scheme are also recognised. While the incidence, if any, of such behaviour is unknown it is apparent that any refining of parameters for calculating assistance should be considerate of such issues. (sub. DR91, p. 2)

Australian Paper said that allegations of scheme abuse are damaging to the integrity of TFES and 'measures to ensure compliance with the moral intent of the scheme will, subject to an impact assessment, be strongly supported' (sub. DR89, p. 3). Similarly, Simplot said that, while it supported penalties 'for anyone found to be rorting the TFES scheme':

> … caution must be exercised not to unfairly minimize the benefit to those recipients acting within the spirit of the assistance program simply as a way to eliminate all possibility of rorting. (DR82, p. 3)

Indeed, many participants who expressed concern about actual or potential problems with the TFES argued that they should be addressed by tighter scheme administration, including greater auditing of claims, while otherwise leaving the

scheme to operate in its current form. The Tasmanian Government reflected the views of many when it stated:

> The integrity of the current scheme and any perceived rorting can be addressed through measures such as the application of stringent risk management by the administrator and better auditing by an independent body. The Australian Government has a responsibility to ensure confidence in the administration of the scheme. The Tasmanian Government and industry supports measures which would increase transparency of the Scheme's arrangements. (sub. DR 88, p. 8)

Similarly, Donald Cameron sought greater use of audits and retrospective examination of past TFES claims (sub. DR92, p. 1).

Warwick Counsell argued that many problems could be addressed by more rigorous application of the Ministerial Directions, particularly in relation to who may claim and on what basis. In his view, if the Ministerial Directions were enforced as intended:

> … there would be no northbound agents (cl 22.1) and all claims would be based on 'wharf to wharf freight bills' issued by ship operators or 'notional wharf to wharf freight bills' derived from them (cl 15.4). (sub. DR81, p. 2)

He added that:

> The Scheme needs updating and fine tuning but, most importantly, it needs effective management by a dedicated team, committed to the application of accounting principles and elementary rules of compliance. (sub. DR81, p. 3)

While administration and auditing procedures may be able to address some matters, many of the Commission's concerns originate in the design of the TFES itself and the structure of its parameters. The inappropriate outcomes reported in chapter 5 in large part arise from claimants responding to the current rules of the scheme and cannot, in the main, be addressed only by changes to administration and auditing procedures, although there may be a case for some such changes. Instead, they require changes to the underlying rules and procedures that are being administered and audited. For such reasons, the Commission has sought to recommend structural changes to the TFES. That said, there may be scope for administration and auditing procedures to better focus on some of the issues raised in this report (see below).

RECOMMENDATION 1

The basis for claiming TFES payments should be restructured to minimise the adverse incentives that the current scheme generates.

To this end, the Commission has examined two options.

- The TFES could continue to be based on the assessed cost disadvantage of individual shipments, but payments only be made on the basis of evidence of actual wharf-to-wharf costs.
- Assistance could be paid on the basis of a single flat rate per TEU.

These are discussed in turn.

The chapter concludes with the Commission's recommendations for assisting shipments of containerised and bulk wheat.

7.1 Require original wharf-to-wharf invoices

The core focus of the TFES is to pay rebates to shippers so as to alleviate the freight cost disadvantage that is attributable to the Bass Strait wharf-to-wharf component of any particular freight journey relative to a road freight equivalent.

Whereas claimants can currently submit invoices for door-to-door transport or other configurations of the freight task as a basis for payment of rebates, a more stringent option is to require shippers to provide original invoices from carriers (that is, ship operators) that include the specific wharf-to-wharf charge. This could then be set against an appropriate road freight equivalent amount and adjusted for additional intermodal costs and other parameters, following the practice of the core of the current TFES payment methodology.

For those shippers who send goods on a wharf-to-wharf basis, a requirement to provide this information to obtain a rebate would present little difficulty. This was confirmed in post-draft-report submissions and at hearings. For example, J. Boag & Son said:

> The use of wharf-to-wharf freight rates as a basis for claiming assistance provides transparency in the scheme and the calculation of appropriate levels of assistance and is therefore strongly supported. (sub. DR78, p. 5)

Major Tasmanian Manufacturers said that this method 'reduces the potential for rorting' and 'is supported by major manufacturers' (sub. DR77, p. 12). They also said that claiming assistance on a wharf-to-wharf basis:

> … also provides scope for ensuring improved compliance with the moral intent of TFES. This could be achieved through shippers signing declarations that relevant wharf-to-wharf freight rates are exclusively limited to the wharfage, stevedoring, container hire and blue water costs associated with shipping across Bass Strait. (sub. DR91, p. 2)

And Norske Skog said:

> During the Public Hearings a number of companies and industry groups put forward suggestions to improve current arrangements and address the perception of rorting or gaming. We believe there is virtually unanimous support for a system based on —

- Wharf to Wharf claims only
- 2-3 year transition period for current Door to Door claimants
- The option for claimants (perhaps small companies or one-off shippers) to accept a flat rate
- Improved auditing and investigation of claims that appear to be excessive when compared to claims made by similar sized claimants for similar products
- Greater transparency, including the publication of more comprehensive annual data and reporting of annual payments to recipient companies
- Agreed annual adjustment mechanism. (sub. DR93, p. 2)

As noted, most large, frequent shippers already make TFES claims on a wharf-to-wharf basis. But, as shown in chapter 2, most individual claims made under the TFES are for door-to-door (or door-to-wharf or wharf-to-door) shipments, which do not include a separately itemised wharf-to-wharf component.

Shippers who send their goods door-to-door have the choice of submitting the door-to-door invoice from the freight forwarder to Centrelink and electing to be assessed by the parameter adjustment method (that is, by initially deducting $230 for the land transport task at either end), or instead opting to be assessed on a wharf-to-wharf basis.

Under the Commission's wharf-to-wharf option, the first choice would no longer be available. In the latter case, Centrelink currently requires a letter from the freight forwarder showing the wharf-to-wharf rates included in the door-to-door freight invoices for that claimant and the period of validity for these rates. A change to wharf-to-wharf claims would not cause significant problems for this group. However, in view of the problems identified in this report, the evidentiary requirements of the TFES should be strengthened by requiring claimants, freight forwarders or agents to make available a copy of the original carrier's invoice to Centrelink.

There are different ways in which this could be achieved. For example, the shipper could be required to obtain from the freight forwarder a bill that separately identifies the wharf-to-wharf component of the total door-to-door freight bill. Centrelink could accept this as evidence of the wharf-to-wharf cost, provided the freight forwarder or agent certified that it was correct and provided Centrelink with the underlying carrier's invoice upon which it was based.

Freight forwarders may consider that providing shippers with itemised bills could undermine the confidentiality of their charges. Generally, claimants who ship door-to-door only know the total door-to-door charge. This reflects, in part, the desire of freight forwarders and agents to keep confidential the sea freight rates they are able to achieve. However, making this an optional part of the TFES requirements might, in time, lead to changes in the practices of some freight forwarders, improving transparency by allowing shippers to better understand their freight costs.

One way to allay such confidentiality concerns could be for freight forwarders to advise Centrelink directly by letter of the wharf-to-wharf rates to apply to particular shippers, but to supplement this with the original carrier's invoice upon which the shipper's door-to-door bill is based. Where the goods of several claimants have been aggregated by a forwarder into a single shipment, the underlying carrier invoice will be common to all of those claimants. Centrelink would need to link each claim to the original carrier invoice in order to verify or audit it. This could increase administration costs, particularly if there are time lags between shipment and claim. Further, this approach may reduce the transparency of the scheme and the claims process, as without an itemised bill to check against, claimants would receive a rebate with little or no basis upon which to challenge it if they thought it to be incorrect. This lack of transparency may also reduce certainty for some claimants.

For such reasons, the Commission accepts that there needs to be some flexibility in how a revised TFES based on wharf-to-wharf invoices is put into practice. It considers that the scheme should be based on original carrier wharf-to-wharf invoices as far as is practicable. It therefore recommends that, subject to this proviso, Centrelink should be free to specify what documentary evidence it will accept as proof of wharf-to-wharf costs, either as part of its day to day administration of the scheme, or during audits of past transactions.

Implementation of this option would not eliminate the gaming of the current scheme to the same extent that a flat rate would. But together with tighter evidentiary requirements, auditing and greater transparency, it should comprise a worthwhile improvement on the current TFES.

RECOMMENDATION 2

Assistance under the TFES should only be payable on the basis of evidence of actual wharf-to-wharf costs:

- ***Centrelink should specify the documentary evidence that it will accept as proof of wharf-to-wharf costs. As far as practicable, this should be based on original carrier wharf-to-wharf invoices.***

- ***Parameter adjustments of $230 per TEU for door-to-wharf and wharf-to-door costs would no longer apply. Other parameter adjustments would continue to be used.***

In the Commission's view, the administration and auditing of such a revised TFES should focus more intensively on the verification of wharf-to-wharf costs. The costs of administering the scheme are likely to be higher as a consequence.

RECOMMENDATION 3

The administration and auditing of the TFES should focus more intensively on the verification of wharf-to-wharf costs:

- ***The systems required to administer the scheme should be updated in the light of the more detailed evidence and data processing needed to verify wharf-to-wharf costs.***
- ***There should be more comprehensive public reporting of information, including the annual payments to recipients.***

Need for revised methodology and parameters

Under such a revised TFES, the door-to-wharf and wharf-to-door parameters of the current scheme would no longer be used. The remaining parameters (such as the distance scaling factors and the road freight equivalent) would remain and would need to be re-estimated. Until then, the current parameters should continue to be used.

DOTARS and the BTRE should revise the methodology for setting and updating the parameters. This should commence immediately, and updates should be undertaken every three years. In particular, consideration should be given to specifying those cost elements encompassed within the definition of wharf-to-wharf costs, in view of the scope for cost-shifting between the intermodal and wharf-to-wharf costs that now exists (section 5.3).

RECOMMENDATION 4

DOTARS and the BTRE should revise the methodology for setting and updating the remaining parameters, and review them every three years. In particular, they should review how wharf-to-wharf costs should be defined. The results of parameter reviews should be published.

Some further implementation issues

The Commission proposes that DOTARS should monitor the operation of the revised scheme to assess whether gaming and overcompensation of wharf-to-wharf costs continue to be an issue and whether the administrative arrangements, audit controls and requirements for additional documentation prove to be effective.

A second set of issues to be monitored relate to the role of non-producer claimants within the TFES. While freight forwarders and freight logistics companies generate the documentation required to assess a TFES claim, they are explicitly excluded from the approved southbound agent arrangements. In the case of northbound agents, they, as well as the shipper client, can now make claims under the TFES, an outcome not specifically provided for under the Ministerial Directions. Some participants argued for tighter controls on agents on the grounds of insufficient transparency of their role in claiming TFES assistance on behalf of the freight tasks they organise for individual shippers.

In monitoring these issues, DOTARS should report on the case for standardising and updating the rules and audit controls that should apply (such as registration, as currently applies to southbound agents). This would allow greater scrutiny of the activities of all such claimants and could provide a measure of reassurance as to their role. The case for allowing freight forwarders, freight logistics companies and other third parties to make claims under the TFES could also be examined at that time.

DOTARS should commence its monitoring immediately on implementation of the revised scheme and provide a report to Government during 2009. In the light of the findings of that report, the Government should consider any appropriate amendments to the operation of the TFES.

If the Government concludes that gaming and overcompensation of freight cost disadvantage are continuing and significant, it should implement a flat rate of assistance, to apply from 1 July 2010 (see below).

RECOMMENDATION 5

DOTARS should monitor the operation of the revised scheme to investigate whether there is evidence of ongoing gaming and overcompensation of wharf-to-wharf costs. It should report to Government on this matter during 2009.

The report should also examine:

- ***the effectiveness of administration and audit controls;***

- ***the role of all actual and potential claimants who are not producers and shippers of goods assisted under the TFES; and***
- ***any aspects of the Ministerial Directions judged to be causing difficulty at that time.***

If the Government concludes that gaming and overcompensation of freight cost disadvantage remain significant issues, it should introduce a flat rate of assistance per TEU as per finding 7.1, to operate from 1 July 2010.

7.2 Pay a flat rate per TEU only

Regardless of the source or destination of freight carried by sea from Tasmania to the mainland, the only component of the freight task which the TFES seeks to assist is the wharf-to-wharf leg across Bass Strait. A simpler, more directly focused and transparent approach to addressing this cost component would be to introduce a single flat dollar rate of payment per TEU for all eligible claimants.

This would have several key advantages. First, and most importantly, it would directly overcome almost all of the adverse incentives and approximations of the current scheme (chapter 5). Because the many parameters currently needed to reduce a freight bill to a notional Bass Strait wharf-to-wharf equivalent would not be needed, the problems that they now generate (chapter 5) would no longer arise. A claimant would not need to provide evidence of its shipping costs, just that it had shipped a particular number of TEUs or TEU-equivalents. In particular, a flat rate would remove the incentives to claim in a way that maximises the wharf-to-wharf component of a freight bill, a practice that has led to overestimation of the freight cost disadvantage and overcompensation for wharf-to-wharf costs, in part by treating some land freight costs as wharf-to-wharf costs.

Second, economic efficiency would be increased. A flat rate would improve the commercial incentives for Tasmanian producers to minimise transport costs, as they would retain the full benefit of any transport cost savings and bear the full cost of any increases. Also, there would no longer be an incentive to arrange freight tasks to minimise freight costs net of the TFES rebate. The focus of shippers would be on the cost and services provided by carriers as the most appropriate gross freight bill would also be the most appropriate bill net of the TFES rebate.

A flat rate regime would be aimed at assisting shippers without distorting behaviour, and as such, would not attempt to address the particular sea freight cost disadvantage of individual shippers. Relative to current arrangements, there would be gainers and losers among shippers, and there would be a redistribution of assistance payments. Those who pay low rates per TEU — commonly, the large,

regular shippers — may be paid a marginally higher proportion of their shipping costs. However, those whose products incur relatively high sea freight costs — who may be smaller, irregular shippers, or those with special packing needs etc — would inevitably meet more of those costs.

However, the current arrangements also provide only approximations of each shipper's freight cost disadvantage and, indeed, have inbuilt incentives to overestimate its magnitude (chapter 3 and chapter 5). The simplifying assumptions and fixed allowances it uses impart an air of precision to its estimation which belies the scheme's actual operation. The parameters, class cut-offs and sliding scale percentages that are dominant determinants of assistance provide no more than practical, workable approximations. Together, they only loosely reflect different sea freight cost disadvantages and provide poor incentive effects for the majority of shipments.

Moreover, while the TFES recognises differences in the cost of sea freight associated with factors such as time, size, regularity and nature of goods shipped, it does not recognise that such factors are also applicable to the notional road freight equivalent that is integral to the measurement of sea freight disadvantage. But goods that incur high wharf-to-wharf sea freight costs would be likely to incur higher than average road freight costs, implying a lower actual freight cost disadvantage than the scheme currently assesses.

Actual sea freight disadvantage is the difference between the sea freight costs paid by shippers and the cost of shipping their particular products on the mainland. Accordingly, a flat rate rebate may not disadvantage small shippers by as much as might be first thought, when account is taken of their actual sea freight disadvantage.

In summary, a flat rate of assistance would overcome significant incentive and compliance problems that are evident under the current TFES. It would provide a direct contribution towards the wharf-to-wharf cost of shipping across Bass Strait, it would be simple to claim and to administer, and it would eliminate current efforts by some to game the scheme. Fewer parameters would be required to set the rate and there would be a redistribution of the quantum of assistance.

Determining an appropriate flat rate rebate

Choice of an appropriate flat rate needs to balance several considerations and, as with the current TFES formula, there is no 'right answer'. The rate payable should recognise that there is a sea freight cost disadvantage, but not overcompensate for it or set in train any adverse incentives.

The Commission analysed all available data on freight rates and freight cost disadvantage. It drew on evidence provided in public and confidential submissions, and on discussions with those who benefit from the TFES. It closely examined the information contained in the TFES database, notwithstanding its limitations. It analysed a broad range of wharf-to-wharf freight rates paid by regular volume shippers of full container loads. It took into account that the TFES database overstates the freight cost disadvantage (chapters 3 and 5) and noted that the various parameter reviews have suggested different rebate outcomes.

On this basis, the Commission's draft report proposed a flat rate of $400 per TEU, based on 2004-05 data for a subset of data on wharf-to-wharf shipments on a full container load basis. It reported that a rebate at that level would be equal to at least half of the actual sea freight costs for about 60 per cent of TEUs shipped and would cover about 73 per cent of the estimated average freight cost disadvantage ($546 per TEU) for that year. The overall cost of the scheme was estimated at $67 million, about $25 million less than current expenditure.

While a few participants acknowledged the potential advantages of a flat rate, most opposed it on the grounds that it was not related to a shipper's freight cost disadvantage, and would redistribute assistance away from those that now receive higher levels of TFES assistance (box 7.1). For example, the Treasurer of Tasmania said that:

> Flat rates of assistance will not reflect the actual cost disadvantage to producers with different wharf-to-wharf costs reflecting the scale, frequency and density of shipments. Flat rates will impact most severely on those manufacturers who are the largest beneficiaries of the freight assistance. (trans., p. 71)

Similarly, J. Boag & Son said that a flat rate:

> [does not] address the fundamental issue of differing levels of disadvantage experienced by each shipper. (sub. DR78, p. 3)

Simplot expressed a view shared many participants when it said that a flat rate set at $400 per TEU would be 'inadequate assistance' and would reduce the TFES payments it received:

> …. Simplot would be approximately 50% worse off under this arrangement than with current assistance levels. (sub. DR82, p. 3)

The Commission considered all of these views very carefully. It accepts that under such a arrangement the scheme would no longer attempt to compensate each shipper for its freight cost disadvantage. It also agrees that a flat rate would lead to a redistribution of assistance away from those that currently receive higher levels of payments.

Box 7.1 **Participants' comments on a $400 per TEU flat rate**

The Tasmanian Government reported that major recipient firms had advised that their investments were dependent upon continuing TFES assistance:

> Tasmanian industries have made significant investments since 1976, on the expectation that freight scheme assistance would continue. This investment by recipients of TFES has enabled them to remain globally competitive. Any material changes in the rules increases the risk that investments will not earn expected returns. (sub. DR88, p. 2)

J. Boag & Son said that a flat rate $400 per container would have a significant effect on its operations:

> This reduced level of assistance would restrict Boag's ability to place its products in the market place at a competitive price given that it is already suffering a significant transport cost differential when compared with its competitors. The proposed reduction in assistance, in today's dollars, would be approximate $1.2 – $1.5 million. (sub. DR78, p. 3)

The Tasmanian Freight Logistics Council said that a flat rate:

> … would disadvantage the very shippers that the TFES is particularly trying to foster — that is the smaller and less than container load shippers who do not have the market power to negotiate volume discounts. (sub. DR85, p. 1)

Major Tasmanian Manufacturers said that a rate of $400 per TEU would adversely affect them and would 'decimate' small manufacturers (trans., p. 35).

Australian Paper said that its Tasmanian operations:

> … would be directly affected to the tune of $1.2 million if we went to the flat-rate scheme of $400 a tonne. (trans., p. 39)

Cadbury Schweppes said that assistance at this level would amount to only half of what it currently receives from the TFES (trans., p. 64).

Cascade said a flat rate payment of $400 per TEU would involve a 40 per cent reduction in the TFES assistance to the company (trans., p. 122).

Harvest Moon said that the current rate that it receives of approximately $800 per TEU is appropriate for fresh vegetables. It added that the company made a profit in four of the past five years and that interstate sales comprise about 40 per cent of its annual vegetable sales that last year totalled $27 million. However, if payment had been made as a flat of $400 per TEU:

> Harvest Moon would have recorded a loss in three out of five years, a break even in one year and a profit in the other. The Company would still have gone broke. (sub. DR72, p. 7)

It supported a flat rate but argued that it would be more appropriate to have several flat rates to reflect differences between various classes of commodities. In its view, $800 per TEU is an appropriate rate for fresh vegetables (sub. DR72, p. 10).

Tasmanian Farmers and Graziers Association expressed a commonly-held view that:

> A flat-rate approach, while administratively attractive, does not meet the fundamental test of being linked to the relative sea freight cost disadvantage. (trans., p. 98)

The Commission has also given considerable thought to other ways of providing freight assistance to Tasmanian shippers — whether based on freight cost disadvantage or on freight cost alone. For example, it considered whether multiple flat rates would better overcome the problems of the TFES. But while this would reduce the redistribution effects of a single rate, it would generate other significant incentive problems and threshold issues. In all cases, there were found to be significant practical or incentive problems that could not be resolved satisfactorily.

In view of this, the Commission remains of the view that many of the endemic problems of the current scheme would be overcome by shifting to a TFES based on a flat rate of payment per TEU.

The choice of flat rate needs to balance a number of factors. First, a flat rate set at any level will reduce assistance for those currently receiving more than that rate, and provide more assistance for those now receiving less. Second, some shippers may receive more than their freight cost disadvantage, as measured by the current TFES. Third, at higher levels of flat rate, some shippers — primarily the bigger shippers who are able to achieve the lowest freight rates — may be paid more than their actual freight costs. In such cases, they would effectively be paid by the government to ship TEUs and would have no incentive to structure their Bass Strait transport in an efficient manner.

The key to the choice is how much redistribution is acceptable and what the incentive effects are likely to be. The rate chosen needs to balance all of these effects.

In the light of more recent data (for 2005-06) that became available after the draft report had been prepared, the Commission re-estimated the likely impacts of providing assistance at different broad flat rates (table 7.1). It found that:

- At $400, one-quarter of TEUs would receive more assistance than at present, while 75 per cent would receive less. Nearly 50 per cent of all TEUs (17 per cent of claimants) would receive more than half of their actual wharf-to-wharf freight costs in TFES assistance. The overall cost would be some $65 million, about $27 million less than current expenditure.
- At $500, 44 per cent of TEUs would receive more assistance than at present, while 56 per cent would receive less. About 72 per cent of all TEUs (36 per cent of claimants) would receive more than half of their actual wharf-to-wharf freight costs in TFES assistance. The overall cost would be $81 million or $11 million less than at present.
- At a rate of $565, which is about the average under the current scheme, half of all TEUs (22 per cent of claimants) would receive more assistance than they now

receive, while just over one per cent of TEUs (5 per cent of claimants) would be paid more than their actual freight cost.

- A markedly higher rate could have significant adverse incentive effects. To illustrate, a rate of $650 per TEU would result in over one-quarter of all TEUs being paid more assistance than their actual freight costs.

Table 7.1 **Compensation of freight costs and freight cost disadvantage**
At different levels of flat rate assistance[a]

	Shipments that would receive more than their current WTW freight cost		*Shipments that would receive more assistance than at present*		*Shipments that would receive more than half of their WTW freight cost*	
Flat rate	*% of TEUs*	*% of claimants*	*% of TEUs*	*% of claimants*	*% of TEUs*	*% of claimants*
300	0.0	0.0	0.8	2.9	24.8	5.7
400	0.8	1.3	24.8	4.8	47.7	16.7
450	0.8	1.8	28.4	7.9	51.8	27.0
500	0.8	3.3	43.6	12.9	71.8	36.0
525	1.0	4.0	46.2	18.6	77.2	40.3
550	1.1	4.4	49.8	20.2	80.9	45.0
560	1.1	4.6	49.8	21.0	80.9	46.1
565	1.1	4.8	49.9	21.5	81.0	46.9
650	27.4	7.7	54.0	32.4	92.5	59.4

a All shipments, full container loads only (86 per cent of total database). Total expenditure estimates are based on all shipments, including LCLs. WTW means wharf-to-wharf. The WTW freight cost is measured as the 'Bass Strait equivalent' cost, as adjusted by the scheme parameters.

Source: TFES database.

After examining the cost consequences of different flat rates and their effect on reducing the estimated sea freight cost disadvantage of a range of shippers, the Commission considers that a rate of $500 per TEU would be appropriate. It is a little under the average assistance provided by the current scheme ($565), but payment at that level would overcompensate shippers on average because:

- current arrangements have inbuilt incentives to overestimate the Bass Strait equivalent wharf-to-wharf cost and, hence, the size of shippers' sea freight cost disadvantage (chapters 3 and 5); and
- more recent BTRE updates (chapter 2), as well as trend data on freight prices (chapter 3) suggest that the road freight equivalent is rising relative to sea freight costs, reducing the extent of actual disadvantage compared to the level currently subsidised by the TFES.

Moreover, a rate of $500 per TEU would provide significant assistance to shippers' sea freight costs without causing major incentive problems through excessive

payment, as less than one per cent of TEUs would be paid more than their actual freight costs, according to the TFES database (table 7.1). In view of the overestimates of freight cost disadvantage in that data, the Commission sees this risk as acceptable.

If a flat rate were to be implemented, rebates should be payable on currently eligible northbound and southbound shipments. While rebates should be payable on a pro rata basis for goods shipped in containers of different sizes or as less than full container loads, no other adjustments should be made.

The flat rate should be reviewed every three years on the basis of sample data on actual wharf-to-wharf shipments costs between northern Tasmania and Victoria, intermodal costs and road freight equivalent costs. This could be undertaken by the BTRE through a confidential survey of shippers, shipping companies, freight forwarders and road and rail freight service providers.

There may be some adjustment pressures

As noted, a flat rate would involve some redistribution of assistance among recipients. Some producers would face significant reductions in assistance, with concomitant adjustment costs and pressures. In all, about 41 per cent of all TFES claimants who ship on a full container load basis receive the maximum rebate of $855 per TEU (on a Bass Strait equivalent basis). However, they account for only 8 per cent of all TEUs shipped. For example, producers of fish (accounting for less than one per cent of all TEUs shipped on a full container load basis) and vegetables currently receive much higher levels of TFES assistance per TEU than many other products, and would receive significantly less under this proposal. (Some such shippers use air freight to service some of the markets for their products.)

Because of its potential impact on some shippers, the introduction of a flat rate of assistance per TEU may need to be accompanied by the provision of a structural adjustment package for Tasmania.

FINDING 7.1

Payment of sea freight assistance as a single flat rate of subsidy per TEU shipped would have significant advantages in overcoming incentive problems and reducing administrative and compliance costs.

- *A rate set to $500 per TEU would be appropriate.*
- *The subsidy would be applied on a pro rata basis for other than full TEU loads. No other adjustments would apply.*
- *The nominal level of the subsidy would be reviewed every three years.*

- *Structural adjustment assistance of up to $10 million each year for three years could be considered, if it were found necessary to alleviate any social and economic hardship that arose from the introduction of the flat rate subsidy.*

A flat rate of assistance would involve a significant redistribution of current TFES assistance.

In view of the considerable redistribution of assistance that a flat rate would involve, and in particular, the impact on shippers who currently pay high sea freight rates, the Commission has not recommended a flat rate at this stage. But if the revised wharf-to-wharf approach proves not to be effective, a flat rate should be introduced from 1 July 2010.

7.3 Change the basis upon which assistance is paid to wheat shipments

At present, the availability of different subsidies for different modes of transport has a major influence on how wheat is shipped (chapter 5). As the TFGA said:

> … the freight rate relativities between containerised and TWFS assisted shipments are distorted. (sub. DR73, p. 5)

As noted in chapter 2, containerised wheat was included in the TWFS until 2003-04, and was paid assistance at the same, flat rate as bulk wheat. The present distortion arose after containerised wheat was included under the TFES.

This distortion could be eliminated by reverting to the arrangements that applied prior to 2004 — that is, by paying the same subsidy per tonne for wheat shipped across Bass Strait, irrespective of how it is shipped. The Commission considers that all wheat shipped in containers and in bulk should again be included within the TWFS and containerised wheat should no longer be eligible for assistance under the TFES.

The TFGA (sub. 35, p. 26) argued that the potential for substitution between wheat and other grains implies that they should be treated similarly.[1] However, the Commission notes that there have been no bulk shipments of other grains in recent years. The Commission does not support expanding the TWFS to include other grains.

[1] The inclusion of other grains may necessitate a different calculation for assistance, as noted by the CIE: 'For other grains a 10 to 15 per cent upward adjustment [in assistance] would be required to allow for the fact that other grains have a higher stowage factor than wheat' (2001, p. 37).

While the cap on total assistance provided under the TWFS has some advantages, it is not consistent with the intent of the current scheme to:

> … assist in alleviating sea freight costs of shipping eligible bulk wheat on Bass Strait so that businesses in Tasmania relying on bulk wheat shipments are not unduly disadvantaged. (DOTARS 2006b)

One consequence is that the rate of assistance per tonne to bulk shipments reduces as demand rises:

> So in a year such as this one where we have a drought, it has potential to have the greatest effect, and the TFES actually supports the less efficient method of transporting grain … (Frank De Bruyn, trans., p. 86)

Reductions in assistance in times of high demand, when Tasmanian users are most reliant on shipments of wheat, diminishes the scheme's effectiveness in alleviating sea freight cost disadvantage. In the Commission's view, the revised TWFS should not be capped.

Calculation of assistance per tonne

In line with the intent of the scheme, the level of assistance to wheat should be based on the sea freight cost disadvantage of transporting wheat across Bass Strait. It should reflect the lowest cost option for transporting grain to Tasmania, and therefore should be based on the difference between the Bass Strait bulk rate and the cost of moving an equivalent shipment 420kms on land.

In estimating the land transport equivalent cost, the TFGA argued that:

> … an effective scheme would recognise that the movement of wheat across Bass Strait occurs in volumes that are more appropriately compared with rail transport than bulk shipping. … the sea-freight cost disadvantage faced by Bass Strait grain movements is most appropriately based on … the existing freight costs and those that would be applicable where a notional land-bridge existed and grain was moved by rail. (sub. 35, p. 29)

Similarly, in its review of the TWFS, the CIE considered that any land bridge approach should adopt a rail (rather than road) freight equivalent:

> The land bridge option is akin to the situation faced by a flour mill in Melbourne which sources hard wheat from a grain terminal in New South Wales. Typically, the wheat would be railed from New South Wales to a domestic terminal in Victoria, then hauled by road to the customer. … Rail rather than road is assumed to be the appropriate mode of transport for estimating a 'freight equivalent' because rail is generally more economical than road haulage over distances greater than 150 kilometres. (CIE 2001, p. 25)

The Commission agrees. In line with the methodology of the TFES, the calculation of assistance under the TWFS should reflect the cost of shipping wheat across Bass Strait, plus any intermodal costs, less the rail freight equivalent. The rail freight equivalent cost has not been estimated since 2001. Further, there have been very few bulk shipments of wheat in recent years (see table 2.4). As such, the Commission considers that — although they should be used in principle — neither of these rates should be used to set the level of TWFS assistance at present. As part of the larger three-year review, the BTRE should establish both a new rail freight equivalent and a bulk shipping rate per tonne, to be updated in subsequent reviews of the level of TWFS assistance.

In the interim, the next best measure of the lowest cost of transporting wheat to Tasmania — the rate for containers sent on the Bass Strait route on a wharf-to-wharf basis — and the most recent road freight equivalent as estimated by the BTRE should be used. This results in TWFS assistance of $23.12 per tonne of wheat transported (see box 7.2). While this may represent a reduction in assistance to some claimants — particularly those who claim on a door-to-door basis — it is the closest practical measure to the current least cost method of shipping wheat across Bass Strait, and as such is in line with the intention of scheme.

RECOMMENDATION 6

The TWFS should pay the same level of assistance per tonne to wheat shipped in containers and in bulk:

- ***Payments under the TWFS should not be capped.***
- ***Wheat should no longer be eligible for assistance under the TFES.***

The level of assistance should be based on the least cost method of shipping wheat across Bass Strait and a rail freight equivalent cost:

- ***Given the lack of recent data on these measures, the Bass Strait wharf-to-wharf container rate and the TFES road freight equivalent should be used in the interim. As such, for three years, the TWFS should pay assistance of $23.12 per tonne, or the shipper's actual wharf-to-wharf cost, whichever is the lesser.***
- ***In concert with the first three-year parameter and operational review of the TFES, the BTRE should estimate the cost of bulk shipments of wheat and the rail freight equivalent, to update the rate of subsidy from that time.***

Box 7.2 **Sample calculation of assistance under the TWFS**

Assistance should be calculated according to the formula:

- Least cost Bass Strait sea freight rate per tonne of wheat
- Plus intermodal costs per tonne
- Minus rail freight equivalent per tonne of wheat on the mainland.

Given the absence of bulk shipments of wheat in recent years, for the purpose of this sample calculation, Bass Strait container rates for wheat are used for the sea freight rate. The average cost is taken from the sample of full container loads sent between northern Tasmania and Victoria on a wharf-to-wharf basis. This is done to avoid any distortions in cost arising from the application of the TFES parameters (see section 3.2). Based on the 2005-06 database, this gives an average rate of $777 per container.

Taking the average tonnes per container within the TFES database of 24.5 tonnes gives a rate per tonne of wheat of $31.73.

Using the most recent BTRE estimate for intermodal costs under the TFES ($113), the intermodal cost per tonne is $4.61.

There is limited data available on a current rail freight equivalent for the transport of wheat. The BTRE (2002) estimated a rail freight cost of 2.75 cents per tonne/km in 2000-01. When converted to current dollars (based on the rail freight producer price index – ABS 6427.0) and across a 420km journey, the rail freight equivalent is $12.32 per tonne.

Using this measure, the level of assistance would be: $31.73 + $4.61 - $12.32 = $24.02 per tonne.

However, there are significant concerns regarding the accuracy of an aggregate measure of rail costs that was last estimated in 2000-01. As such, the Commission considers that, until the BTRE establishes a new rail freight equivalent, the latest road freight equivalent applicable under the TFES ($324 as estimated by the BTRE) should be used. This gives a freight equivalent of $13.22 per tonne.

Under this approach, the level of assistance would be: $31.73 + $4.61 - $13.22 = $23.12 per tonne.

A Inquiry processes and consultation

A.1 Introduction

Following receipt of the terms of reference, the Commission placed advertisements in national and metropolitan newspapers and other publications, inviting public participation in the inquiry. An initial circular was distributed in March 2006. The Commission released an Issues Paper in April 2006 to assist participants to prepare their submissions.

Public hearings were held in Canberra, Hobart, Launceston and Melbourne during September and October 2006.

The Commission also consulted with a range of interested parties, mainly in Tasmania. A listing of the meetings and informal discussions undertaken is provided below.

The Commission received a total of 93 submissions — 65 prior to the release of the Draft Report and a further 28 after its release. A list of submissions is given in table A.1. All submissions with the prefix 'DR' were received after the release of the Draft Report. (An asterisk indicates that the submission contains commercial-in-confidence material.) All public submissions may be read on the Commission's website.

The Commission thanks all those who have contributed to the inquiry.

A.2 Submissions

Table A.1 Submissions received

Participant	*Submission no.*
Agricultural Contractors of Tasmania Inc	8
ANL Container Line Pty Ltd	42
Auspine Tasmania	44
Australian Paper	34, DR71, DR76, DR89

Table A.1 continued

Participant	*Submission no.*
Baker, Mark (Federal Member for Braddon)	22
Blundstone	29*
Brohier, Peter	2, 3*, 7, 56, 57, 62, 63, 64
Cadbury Schweppes Pty Ltd	33*, DR83
Calvert, Senator the Hon. Paul	51
Cameron, Donald	DR92
Cascade Brewery	4, DR69, DR79
Caterpillar Underground Mining Pty Ltd	36
Cement Australia	23, 58*
Circular Head Dolomite	41, DR87
Classic Foods Pty Ltd — Tasmania	28
Counsell, Warwick	18, DR81
Cox, Carol	DR86
Cuthbertson Bros Pty Ltd	20
Department of Transport and Regional Services	53
Elders Ltd	54
Ferguson, Michael (Federal Member for Bass)	39, 65
Forest Industries Association of Tasmania	46*
Forests & Forest Industry Council of Tasmania	47
Fruit Growers Tasmania Inc	32
G. J. Sales	1
Greenham Tasmania Pty Ltd	16*
Gunns Ltd	48*
Harvest Moon	15*, DR72
Haywards Pty Ltd	50
J Boag & Son Pty Ltd	DR78
King Island Council	6, DR80
King Island Regional Development Organisation Inc	25
KM & WA Kelly & Sons	30
Mader International Pty Ltd	49
Major Tasmanian Manufacturers	DR77, DR91
Maritime Union of Australia	59
McCain Foods (Australia) Pty Ltd	DR67

Table A.1 continued

Participant	*Submission no.*
McNamara, Patrick	27, DR90
Monds & Affleck and Tasmanian Grain Elevators	DR75
National Foods Ltd	37
Net Sea Freight — Tasmania Pty Ltd	26, DR70
Norske Skog Paper Mills (Australia)	24, DR93
Page Transport Pty Ltd	14
Premium Fresh Tasmania	12
Roberts Ltd	19
Rural Logic Australia Pty Ltd	DR84
Sherry, Senator Nick	55
Simplot Australia	13*, DR82
Tasmanian Chamber of Commerce and Industry	DR74
Tasmanian Farmers & Graziers Association and Tasmanian Chamber of Commerce and Industry	35
Tasmanian Farmers & Graziers Association	DR73
Tasmanian Farmers & Graziers Association (King Island)	40
Tasmanian Feedlot Pty Ltd	43
Tasmanian Flour Mills Pty Ltd	17
Tasmanian Freight Logistics Council	11, DR85
Tasmanian Government	52, DR88
Tasmanian Island Pork Alliance Inc	45
Tasmanian Lupini Enterprises	61
Tasmanian Transport Association	5
Tassal Group Ltd	10*
Toll Tasmania	31*
Veolia Environmental Services	21
Victorian Government	60
Wells, John	38*, DR68
Weston Animal Nutrition	9

* Denotes Commercial-in-Confidence submission.

A.3 Meetings with interested parties

The Commission met with the following interested parties, either individually or as part of roundtable discussions held in Tasmania.

Australian Capital Territory

Department of Transport and Regional Services

Tasmania

Agricultural and Resource Management Consulting
AusPine Tasmania
Australian Paper
Blundstone
Cadbury Schweppes Pty Ltd
Carter Holt Harvey
Cascade Brewery Company Pty Ltd
Centrelink Tasmania
Circular Head Dolomite
Davey and Maynard
Doric Engineering
Elders Ltd
Elders Webster
Fruit Growers Tasmania
G. Morris Farm Services
George Hurst Transport and Logistic Services
Gunns Timber
J Boag and Son
Jet Air Pty Ltd
Kelp Industries Pty Ltd
King Island Council
King Island Dairies Pty Ltd
Launceston Chamber of Commerce
Monds and Affleck
Monson Shipping
Muir Engineering
National Strategic Services

Net Sea Freight — Tasmania
Norske Skog Paper Mills (Aust) Ltd
Pivot Fertiliser Sales and Service
Tasman Group Services
Tasmania Freight Logistics Council
Tasmanian Farmers & Graziers Association
Tasmanian Government departments
Tasmanian Transport Association
Thorpe Transport

Victoria

Department of Infrastructure
Peter Brohier
Toll Shipping
TT-Line

A.4 Public hearings

Public hearings were held in Canberra, Hobart, Launceston and Melbourne. The participants who attended were as follows.

Canberra hearing – 25 September 2006

Peter Brohier

Hobart hearing – 17 October 2006

Major Tasmanian Manufacturers
Australian Paper
Cadbury Schweppes

Launceston hearing – 18 October 2006

Tasmanian Government
Agricultural Contractors of Tasmania
Net Sea Freight Tasmania
Tasmanian Grain Elevators Pty Ltd and Monds & Affleck Pty Ltd
Tasmanian Farmers & Graziers Association
Tasmanian Chamber of Commerce and Industry

Melbourne hearing – 20 October 2006

Cascade Brewery
Rural Logic Australia Pty Ltd
Australian Paper
Simplot Australia

B The Prime Minister's statement of 7 September 2006

The Prime Minister made the following statement at the time of the release of the Commission's draft report.

Media Release

TASMANIAN FREIGHT EQUALISATION SCHEME

The Government will not be implementing the proposals in the draft Productivity Commission Report into Tasmanian Freight Subsidy Arrangements.

The Government will not be phasing out the Tasmanian Freight Equalisation Scheme and will not be abolishing the Tasmanian Wheat Subsidy Scheme.

The Tasmanian Freight Equalisation Scheme was introduced by a Coalition Government in 1976. The Scheme remains an important element of Australian government programmes that equalise cost disadvantages between the States and Territories.

The Government will continue to review Tasmanian freight subsidy arrangements to ensure they are operating as intended and to the benefit of all Tasmanians.

I wish to thank my Tasmanian colleagues for the representations they have made to me on this issue. These representations have been instrumental to the Government's decision to maintain the current arrangements.

07 September 2006

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