Australian Government
Productivity Commission

Tasmanian Freight Subsidy Arrangements

Productivity Commission Inquiry *Overview*

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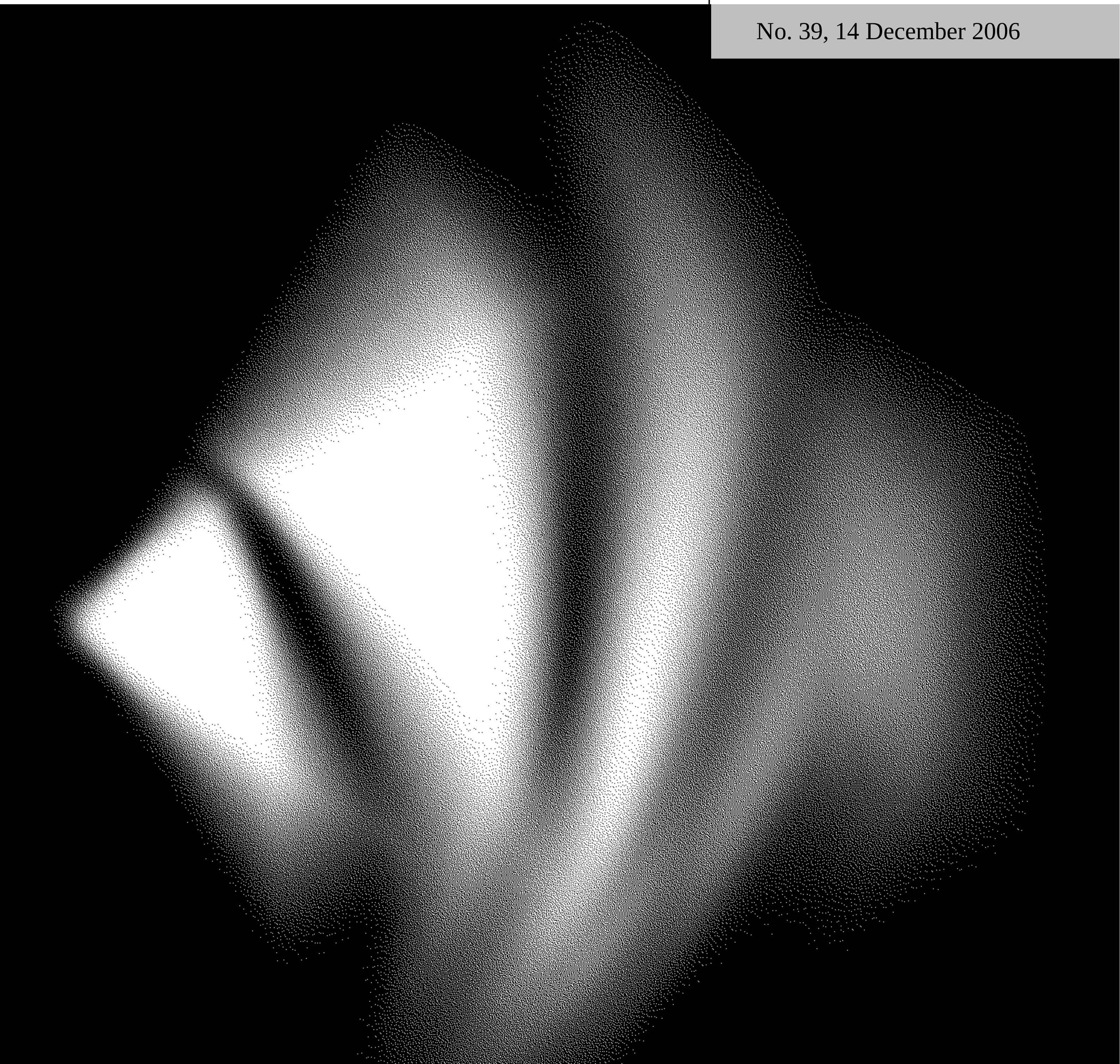

Key points

- 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.