Tasmanian Freight Subsidy Arrangements

Productivity Commission Submission
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Tasmanian Freight Subsidy Arrangements Inquiry
Productivity Commission
P.O. Box 80
Belconnen
ACT 2616

15th June 2006

<u>Re: Tasmanian Freight Subsidy Arrangements</u>

Dear Commissioners,

The following submission by Kelly & Sons responds to issues raised in the Productivity Commission Issues Paper dated April 2006. The comments are focused on the application of subsidies to the importation of mainland grain for use in Tasmanian based grain industries.

Background

Kelly & Sons is a private grain trading and storage company based in Southern New South Wales. Kelly & Sons trades a wide range of grains, legumes and pulses within the grain industry and supplies these types of commodities to Tasmanian based grain users. Supply is typically provided on a delivered Tasmanian wharf, or delivered Tasmanian customer depot basis.

Kelly & Sons pack consignments into containers and transports these to wharf via rail for presentation to shipping services for Tasmania. Kelly & Sons believes its supply chain arrangements between mainland country terminal and mainland wharf are amongst the most efficient in the industry

Scope of the submission

This submission focuses on issues associated with grain. Kelly & Sons believes that this review provides an ideal opportunity to make operational changes to the TFES to remove distortions associated with current arrangements.

Requirement for an ongoing TFES

The Commission has asked whether:

- There is a need for ongoing freight subsidies;
- The TFES creates costs for non subsidized Tasmanian industries; and
- If the policy outcomes could be more efficiently achieved through other means.

These issues are addressed as follows:

Need for ongoing freight subsidies

The TFES allows Tasmanian based grain processing, either through milling, malting, or stock feed use, to occur on a costs basis competitive with mainland use and end product sale. Competitiveness is delivered at both the commodity input stage, and where end markets are mainland or export based, on an end market at export or metro mainland parity basis.

In the absence of the TFES, and for bulk wheat the alternative Tasmanian Wheat Freight Scheme ("TWFS"), it is unlikely that any additional development of grain based industries would occur in Tasmania, and indeed in some instances local processing would be vulnerable to closure.

Tasmania is not self sufficient in grain production. It is not agronomically suited to producing milling quality wheats', and has the potential to meet around 50% of demand for other grain uses. From an agronomic perspective and alternative land use perspective, it is improbable that Tasmania could expand production materially from current levels and would not achieve self sufficiency if the TFES and TWFS were terminated for grains.

Indeed, the importation of mainland grain is symbiotic with local grain production for the following reasons:

- Imported grains provide for a more diverse range of grains, legumes and pulses than can be produced locally. This range of commodities is important to produce nutrionally balanced diets for livestock feeding; and,
- They provide processors, such as malsters, flour millers, dairy farmers & cattle feedlots confidence that in the event of poor seasonal quality or yield, mainland stocks can be sourced on a basis that leaves them with no competitive disadvantage. This knowledge is an important factor that helps to encourage investment and ongoing operations in Tasmanian based processing of Tasmanian grains.

Transportation of grain involves the transportation of low value bulk commodities. For grains the TFES (and TWFS) addresses a cost disadvantage of around 10 to 15% to grain input prices for Tasmanian based use, comparable to mainland input costs. Given grain processing and downstream food production industries are mature and operate in a commodity market, margins are accordingly narrow. Significant capacity exists in these industries on the mainland, so Tasmanian grain processors and food producers face mainland competitive pressure.

Abolition of the TFES (and TWFS) would create strong economic incentive to ship higher value finished goods (flour, malt, retail packed chickens etc) to the Tasmanian consumer, at the expense of Tasmanian processing/production with direct employment and economic consequences in regional Tasmanian communities. Tasmanian grain processors and food industries do not have the capacity to absorb freight cost disadvantages that are associated with Tasmanian grain use.

Costs for non subsidized Tasmanian industries

For the reason described above, Kelly & Sons do not believe that Tasmanian production is forgone through the existence of the TFES (and TWFS).

To the extent there is an externality, it is limited to the pricing of Tasmanian produced grains. The TFES and TWFS ensure grain produced in Tasmania is priced on a mainland parity basis. Were these schemes to cease, local prices would arguably move to an import parity level (mainland parity plus southbound freight) as the State is likely not to achieve self sufficient supply.

Other policy alternatives

Kelly & Sons has no views about other potential policy settings that may be employed to achieve the objectives of the TFES (and TWFS).

<u>The need for TWFS and TFES programs for wheat</u>

Kelly & Sons believe that it is vitally important that the shipment of containerized wheat should be permitted under the TFES.

There are elements of a natural monopoly on handling & shipping associated with the limited infrastructure available for the bulk shipment of grain to Tasmania and its bulk receival, handling and storage at Tasmanian ports. This derives from:

<u>Tasmanian bulk handling assets</u>

- There is one bulk import terminal;
- The import volumes, now and into the conceivable future are insufficient to underwrite the development of a competitive additional handling asset;
- The terminal was privatized in 2003. No pricing or access regimes apply to this asset, so there are no statutory limitations on monopoly behaviour by the operator.

<u>Available shipping</u>

- The import terminal has no unloading equipment and limited storage capacity, limiting shipping to self discharging vessels of around 6,000 tonnes;
- 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.

The application of the TFES to wheat therefore provides a competitive discipline to the operators of bulk grain handling and maritime freight services provided to Tasmania. Additionally, for many smaller wheat users, inland distribution costs associated via containers is more efficient in logistics and/or stock funding costs than bulk shipment.

Conversely, it may be argued that the TWFS should be made available to other grains as a competitive discipline to Bass Strait container freight operators.

Kelly & Sons believe that removal of any grain commodities from the TFES is likely to create consumer transfers to the owners of bulk handling and shipping assets.

Improving and simplifying the TFES

Kelly & Sons believe that the TFES needs to be reformed in two ways:
- Making the party paying the freight the TFES subsidy recipient; and,
- Simplifying the basis of claims to 'wharf to wharf' only.

Claimant reform

Under current arrangement, when a Tasmanian End User calls for tenders on a delivered Tasmanian (wharf or depot) basis, the prices tendered are defined in gross terms, as the seller/shipper cannot always claim the TFES subsidy. The buyer then in turn has to calculate the likely TFES subsidy to estimate the net delivered cost. Generally only the Tasmanian based user can make and receive the TFES claim with Tasmanian Assistance Services. However some licensed importers can claim for small users.

As the subsidy can vary depending on the door to door pathway, the buyer can on occasion incorrectly calculate the net price and thus make an economically inefficient sourcing decision. This is at the expense of higher subsidy cost.

Grain users that buy on a delivered Tasmanian depot/wharf basis typically do so as they lack experience in managing the freight task and it is not their core business. Nevertheless despite the limited skills in freight management, they are expected under the TFES to sort through competing grain offers and models which, when combined with the potential TFES subsidy will yield the lowest net cost.

Kelly & Sons has seen buyers actively choose the grain offer with the biggest associated TFES subsidy when choosing between multiple offers that provide broadly the same net cost, because it looks impressive to have maximized the TFES benefit.

Additionally, as the Tasmanian buyer generally must make the TFES claim rather than the shipper, it is hard for the shipper (e.g. Kelly & Sons) to pass through shipping cost variances (such as fuel surcharges) that arise during the life of a contract. When this occurs, it is only possible for a shipper to recover these costs if:
- The buyer accepts to increase the gross cost; and,
- The buyer is thereafter prepared to adjust its TFES claim.

In practice this does not occur. Accordingly shippers have to build some conservative element into their offers (at the risk of loosing business), and/or loose margin when such adversity arises: either way the liquidity and competitiveness of offers to supply grain are diminished.

Kelly & Sons believes that the TFES would be more efficient if seller/shippers could claim the TFES subsidy. It would:

- Allow all offers to customers to be provided on a net basis;
- Allow seller/shippers to minimize the assumed freight rates in offer prices;
- Alleviate buyers from the need to manage freight claims etc; and,
- Remove the buyer incentive to select the offer with the maximum subsidy.

<u>Basis of claims: wharf to wharf only</u>

The TFES allow applicants to submit claims on either:

- A door to door basis;
- A wharf to wharf basis;
- A door to wharf basis or;
- A wharf to door basis.

Kelly & Sons strongly advocates that TFES claims be conducted only on:

- a wharf to wharf basis; and,
- for grain to be calculated from/and to Melbourne wharf as the most proximate major supply point for grains and as Australia's largest container port.

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.

The ability to choose between making a door to door or a wharf to wharf claim produces the following anomalies:

- The subsidy available with a door to door claim increases to absolute terms (albeit on a declining proportion of total cost) as that total cost increases. Therefore those with inefficient supply chains either side of the wharf to wharf freight leg, can get a bigger aggregate subsidy than efficient operators. Operators' at least efficient mainland sites typically are already compensated for their high cost structure, as mainland grain markets typically trade at a discounted local depot price to reflect the high cost structure to port. For these operators, the higher aggregate subsidy that comes from a 'door to door' claim (compared to a 'wharf to wharf' claim or a 'door to door' claim from an efficient site) represents a windfall profit at the expense of the TFES. Therefore, perversely the 'door to door' subsidy calculation encourages supply from the least efficient mainland grain depots, which is not a desirable public policy outcome;
- The door to door, door to wharf or wharf to door calculation allows thousand of freight cost permutations. It is difficult for the TFES administrators to check the accuracy of those claims. In addition there is only a limited audit process in place, so there is no serious discipline on the claimant to accurately submit their claims, thus this method is open to administrative abuse;
- Suppliers with efficient depot to wharf arrangements (such as Kelly & Sons) receive a lower subsidy; and,

- At the end of the process, the inefficient supplier can display the lowest net cost to buyers, just because of a disproportionally higher freight subsidies.

If TFES subsidy calculations were limited to wharf to wharf costs only, then the market will ensure that grain is shipped from the most freight efficient mainland supply points, and similarly intra Tasmanian delivery will occur on the most efficient basis.

Furthermore, with a wharf to wharf subsidy, at a moment in time all claimants for a single commodity type (e.g. wheat) will receive an identical subsidy. This will make the subsidy;

- More transparent;
- Easier to monitor and administer; and,
- Less susceptible to abuse.

Adoption of a wharf to wharf only subsidy would also put the TFES on an equal footing to the TWFS.

Conclusion

Kelly & Sons believes there is an ongoing role for the TFES for all grains and the TWFS for wheat, and that through administrative simplification it can become more effective, less susceptible to distortions, easier to administer and less susceptible to abuse. To achieve this Kelly & Sons advocates:

- A move to shippers becoming the TFES claimants;
- TFES subsidies being limited to wharf to wharf costs only; and,
- Any change should be subject to a phase in period to accommodate existing contracts.

Additionally, Kelly & Sons believes that the ongoing application of the TFES to wheat is essential to prevent monopoly abuse of market power by bulk shippers and handlers of wheat.

Kelly & Sons will welcome any questions or clarifications from the Commission and is prepared to verbally present this submission to the Commission if requested.

Yours sincerely

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Chris Kelly
Managing Director
KM & WM KELLY & SONS