Australian Paper

PRODUCTIVITY COMMISSION INQUIRY INTO TASMANIAN FREIGHT ASSISTANCE ARRANGEMENTS

PUBLIC RELEASE

Submission
October 2006

M-Strad Pty Ltd
ABN: 74 103 254 879

For information on this document, please contact:

Simon Talbot,
Corporate Relationship Manager
Australian Paper
307 Ferntree Gully Road
Mt Waverley Vic 3149

(03) 8540 2382

Manfred Ruzsicska
M-Strad Pty Ltd
PO Box 316
Lara Vic 3212

E-mail: admin@m-strad.com.au
Tel: +61 412 243 167
Tel: 0412 243 167

M-Strad Reference 0605TFESAP

CONTENTS

EXECUTIVE SUMMARY

Economic Impacts

80% of Australian Paper's (AP) Tasmanian production is unique in the Australian context in that it can't be produced anywhere else in Australia due to that fact that it is machine coated and no other coater exists. The remaining 20% could be produced at our Maryvale plant (however it may displace more profitable grades) thus is would most probably be imported.

With considerable spare production capacity in the global context, any production shortfall will be made up through increased imports, most likely from Indonesia and China.

In this regard TFES assistance is vital to sustaining Australian Paper's Tasmanian mill operations, especially in the current depressed price and flat demand market. At the current levels of contribution, the loss of the company's Tasmanian mill operations would equate to an estimated $1.1billion 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 estimated at 2,400 full time jobs.

The Australian Government's return from AP's Tasmanian operations in taxes alone is 6.5 times the assistance provided to address the sea freight cost disadvantage incurred in shipping across Bass Strait.

Supply Chain Impacts

In Australian Paper's case TFES addresses the sea freight cost disadvantage for the annual southbound movement of 1,150 TEUs of clay[1] and the northbound movement of an estimated 11,610 TEUs of finished paper. These movements are undertaken using customised containers and highly efficient Ro/Ro shipping operations. The supply chain is continually being examined and acted upon to improve efficiency and productivity.

Under the current approach to the calculation and payment of TFES assistance Australian Paper has not identified any instances where the freight task would be undertaken differently in the event that it had additional resources equivalent to TFES assistance. That is, there is no evidence of distortion in market behaviour.

However, marginal reductions in the level of TFES assistance would have significant impacts on supply chain efficiencies and costs through the potential loss of economies of scale and the varying impacts this would have at different points of the supply chain. E.g. there is a point at which the capital cost of maintaining a heavy lift capability for unloading containers will not offset the higher freight

[1] Clay is used as white pigment and coating material in the manufacture of paper.

costs that might be incurred in using side-loading container trucks and or non-containerised vehicles.

Assistance Parameters

It concerns Australian Paper that notwithstanding the recommendations of the TFES Review Authority and the Ministers Directions for TFES during a period of rapid productivity improvements for road vehicles (better than 15% since the current method of calculation was instituted) there is no evidence that the key assistance parameters have been reviewed since the revised scheme was implemented in 1999

Australian Paper has investigated some of the key parameters pertinent to its operations and these investigations point to the current Road Freight Equivalent rate of 66.9c/TEU equivalent/km being substantially higher than the company's experienced rate.

There are also indications that the current calculated estimate for Fixed Intermodal Costs understates the true burden of intermodalism for Bass Strait Shippers. The Fixed Cost allowance should be increased from $100.00 to $139.40.

While Australian Paper recognises the need for incentives to reduce transport costs, this must be based on equitable consideration of enterprises' capacity to negotiate lower rates. To some extent this notion has been captured in the calculation model's declining rates of compensation according to the relationship between actual and median disadvantage.

However, of acute concern to Australian Paper is that the recent Australian Government approved rationalisation of shipping service providers on Bass Strait which will diminish the opportunity to competitively source and negotiate lower sea freight rates.

Accordingly it is recommended that the proportion of notional wharf-to-wharf entitlement paid to claimants with a wharf-to-wharf disadvantage lying between 0.5 and 1.0 times the median wharf-to-wharf disadvantage be set at 85% versus the current level of 75%.

TFES Rationale and Issues

The Tasmanian Freight Equalisation Scheme 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.

However, it is observed 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:

– Investing in improving land transport infrastructure, coupled with the development of national standards etc. for vehicle operations;

- Facilitating and supporting significant restructuring of stevedoring activities through measures such as the funding mechanisms provided through the Stevedoring Levy and associated support;
- Perpetuating high operating cost structures in Australian coastal shipping; and
- Endorsing the rationalisation of Bass Strait operators with consequent loss of competition in key market segments.

While some initiatives, such as the first two, are applauded it is apparent that with respect to transport across Bass Strait these investments are having perverse impacts. These investments are improving the distribution efficiencies of importers in the Australian market and progressively eroding the competitive advantage of Australian production facilities located in Tasmania. The latter approaches are inhibiting and/or reducing the scope for competition and the accompanying cost savings that might accrue to Bass Strait shippers.

In this economic and policy environment TFES has proved to be a focussed and highly targeted program that addresses a specific objective, "the reduction of the sea freight cost disadvantage", in a highly effective manner. That there is scope for improvement is apparent. Parameters need to be adjusted regularly, certainty needs to be improved etc. but the underlying model is regarded as being particularly robust. Any departure from the current model on the basis of simplification e.g. through flat rates of assistance, would only increase the discrepancies between shippers in terms of assistance received and lead to market distortions.

Australian Paper does recognise 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.

In examining the eligibility of inputs to production and subsequent outputs to receive TFES assistance, Australian Paper regards that the underlying principle should be what the notional disadvantage is that the shipper is incurring in moving product. As such the movement of mini-bulk movements should be assisted according to how the product might best be moved over a comparative distance between mainland states. On this basis the competitive relativities between the modes would be re-established.

The loss of the Australian Government's ongoing commitment to address the interstate "sea freight cost disadvantage" across Bass Strait would be an insurmountable hurdle to the ongoing viability of Australian Paper's Tasmanian operations.

To highlight the impact of the current market and difficulties operating in regional areas - we have had to permanently close our S1 Shoalhaven machine in Bomaderry (NSW) reducing the workforce by 45%.**Error! Reference source not found.**

1. INTRODUCTION TO AUSTRALIAN PAPER

PaperlinX is a leading international paper merchant and a leading Australian manufacturer of fine communication papers and high performance packaging papers.

Our products and services include: Office Papers, Printing and Specialty Papers, Packaging Papers and Paper Merchanting and Distribution Services.

Australian Paper is the only paper manufacturing operation in the PaperlinX Group, supplying communication and high performance packaging papers to the Australian market through sales to PaperlinX Merchanting operations and other third-party merchants and packaging manufacturers.

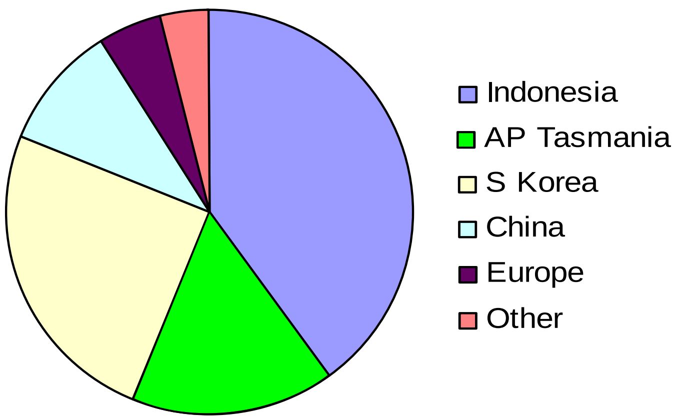
In 2005 Australian Paper directly employed approximately 2000 Australians, predominately in regional locations. The Tasmanian operations employed some 650 people across the Burnie and Wesley Vale plants.

The Wesley Vale Mill is equipped with two pulp mills, one paper machine and one off-machine coater. It can produce 40,000 tonnes of pulp and 135,000 tonnes of coated and uncoated papers for publishing, business forms, and printing. Fibre sources used at Wesley Vale include plantation pine, plantation eucalypt and regrowth eucalypt.

The main fibre source for Burnie Mill is imported pulp. Its two paper machines can produce 128,000 tonnes of paper per year. Most of this is plain paper for forms-grade photocopying, offset printing and base paper which is coated at Wesley Vale Mill.

80% of the paper products produced in the Tasmanian Operations are unique and not available via any other Australian Manufacturer - any shortfall or reduction in the Tasmanian Production is met predominantly by Indonesian or Chinese imports. See Figure 1

Figure 1 - Composition of Australian Coated Paper Market by Country of Origin, 2005



Source: Australian Paper, Internal Market Assessment 2004/05

A full economic impact of the Burnie and Wesley Vale Operations is detailed in the attached report:

2. IMPORTANCE OF TFES ASSISTANCE

At present earnings in the Paper industry are depressed with flat global demand for paper, increased supply and an increase in cheap imports into the Australian market. These factors are magnified by:

1. The Strong Australian dollar through:
   – lower average Australian paper selling prices;
   – reduced receipts from exports; and
   – increased competition from lower priced imports;
2. Increasing distribution costs;
3. Increasing raw material and energy costs in line with oil and other commodity price movements. And,
4. A Static Australian paper market;

In the absence of viable investment alternatives, Australian Paper's Tasmanian operations must continue to reduce costs and ensure that additional costs do not occur in the business. This includes a comprehensive review of domestic customer requirements, with the provision of best quality products at the lowest possible cost.

[redacted]

[redacted]

Critically in this context, the comparative significance of TFES as a proportion of finished product value is less important than its role in providing the Tasmanian paper mills with the continuity of operation that will help the Tasmanian operations reach the next cyclical upturn in the market.

All of the above has already manifested itself into stark reality for AP with the permanent closure of our Shoalhaven No.1 machine in Bomaderry (NSW); an event which resulted in a workforce reduction of 45%.

3. ECONOMIC CONTRIBUTION OF AUSTRALIAN PAPER

Australian Paper recently commissioned an assessment of the Economic Impact of its operations on the Australian Economy[2]. An extraction of pertinent findings for the Tasmanian operations are summarised in Table 1.

Table 1 – Upstream contributions of Australian Paper's Tasmanian Mill operations to the Australian Economy 2003/04

	Burnie Paper Mill *Cut Reams, Uncoated Sheets and Reels*	Wesley Vale Paper Mill *Coated Woodfree Sheets and Reels*	Australian Paper Tasmanian Mill Operations **TOTAL**
Contribution to the Australian Economy			
Output	$146m	$266m	$412m
GDP	$55m	$92m	$147m
Household income	$25m	$80m	$105m
Full-time equivalent jobs	470	1,100	1,570
Contribution to Government Revenue			
Taxes on products & production	$4.3m	$7.5m	$11.8m
State Tax	$2.2m	$3.7m	$5.9m
Income Tax	$7.1m	$12.0m	$19.1m

Source: Western Research Institute, Economic Impact of Australian Paper on the Australian Economy, 5 Aug 2005, pp6-8

The Western Research Institute report focused on the upstream or purchase impact of Australian Paper on the Australian economy. Such impacts occur as a result of purchases of inputs to production including raw materials, energy, transport and wages. These impacts do not include the effect of sales of Australian Paper products (downstream effects) such as wholesale trade operations and transport between wholesale and retail traders.

These estimates are regarded as being particularly conservative in view of the applicable employment multipliers developed by the Australian Bureau of Statistics.

3.1 Employment and Government Revenue

It is worth noting that the employment estimate is regarded as being highly conservative with Australian Bureau of Statistics (2003 Labour-force Analysis) indicating a 5 times employment multiplier as being more appropriate. This estimate can be substantiated on two counts:

(a) It is more consistent with the highly skilled, workforce engaged in Australian Paper's Tasmanian operations. The average income for the company's Tasmanian employees is higher than

[2] Western Research Institute, Economic Impact of Australian Paper on the Australian Economy, August 2005

average Australian average earnings.[3] Disposable incomes will be proportionally even higher with consequent multipliers into the broader economy; and

(b) The recent identification of a number of business operations that are totally dependent on the continued operation of Australian Paper in Tasmania. The combined employment of these operations is well in excess of 300 full time employees supported by Australian Paper's purchases of over $54 million annually. There are additional companies for whom Australian Paper's significance as the provider of base load demand would underpin their continuing viability.

> ***"Government is the major beneficiary when production increases and the major loser when production decreases."***
> Simon Talbot
> Corporate Relationship Manager

Reflecting the Australian Bureau of Statistics multiplier the income tax contribution directly linked to the Tasmanian operations of Australian Paper is actually in the order of $29.1 million. The Australian Government's return is 6.5 times the equity assistance provided to address the sea freight cost disadvantage incurred in shipping across Bass Strait.

3.2 Foreign Trade

Australian Paper's Tasmanian operations currently produce in the order of $260 million of product for the Australian market with a further $33 million of product destined for export markets.

> ***"In the absence of TFES, $1.1b of Tasmanian paper production would potentially be lost from the Australian economy over the next ten years."***
> Simon Talbot
> Corporate Relationship Manager

80% of Australian Paper's Tasmanian production is unique in the Australian context, however not so in our region with considerable surplus manufacturing capacity in both China and Indonesia. In the absence of Australian Paper's Tasmanian operations this production capability would not be replicated on the Australian mainland.

The contribution of the Burnie and Wesley Vale Mills to the balance of trade is $176 million[4] and based on current year results this would equate to a present value in excess of $1.1 billion over the next ten years.

3.3 Tasmanian Investment

Since the 1999 introduction of the current method of calculating TFES assistance and the accompanying rolling five year commitment to its continuation, Australian Paper has invested almost $44 million in capital expenditure at its Burnie and Wesley Vale Mills. While future investment is predicated on both need and opportunity; it is worth noting that, in addition to its regional employment and foreign trade benefits, TFES assistance facilitates a steady stream of capital investment into north western Tasmania.

---

[3] Australian Bureau of Statistics, 6302.0 Average Weekly Earnings, Australia, Feb 2006 compared with average Australian Paper employee income.
[4] Australian Paper, analysis of current sales with allowance for production inputs sourced internationally and the extent of import substitution likely to occur.

4. AUSTRALIAN PAPER'S TFES FREIGHT TASK

The key features of Australian Paper's freight task as it relates to Tasmanian Freight Equalisation Scheme (TFES) assistance are the annual movement of 23,000 tonnes of clay[5] from a processing plant at Ballarat, Victoria, to the Wesley Vale Mill in Northern Tasmania and the northbound movement of an estimated 198,000 tonnes of finished paper. The latter comprises uncoated reams of paper, coated sheets and coated reels.

Transport of clay is effected in approximately 1,150[6] TEUs with an average payload in the order of 20 tonnes. These containers have been configured around Australian Paper's unique requirements. They are equipped with top loading hatches to maximise loading efficiencies and end chutes to facilitate efficient discharge.

Finished paper is similarly transported in approximately 11,610[7] containers with an average payload of 17.12 tonnes. Historically finished product shipped north across Bass Strait incurred unacceptable levels of damage. Reflecting Australian Paper's commitment to continually improve performance, the company now uses containers customised with a smooth internal finish to minimise the incidence of damage in transit.

> ***"Improved supply chain efficiencies are continuously sought as part of Australian Paper's approach to pursuing market opportunities and competitive advantage."***
>
> Phillip Porter
> National Logistics Manager

Australian Paper periodically tenders for the provision of transport services for its Bass Strait movements. These are currently delivered through Toll Shipping's daily shipping service between Burnie and Melbourne's Webb Dock. This service employs cutting edge Ro/Ro cargo handling technology, including MAFI roll trailers[8], to achieve loading and discharge performance superior to that of traditional lift-on lift-off operations. Combined with the requirement for reliable, timely and frequent shipping services there is little scope in Australian Paper's highly optimised freight operations to make use of one-off instances where foreign flagged operators avail themselves of the Commonwealth Government's continuous and single voyage permit system.

For northbound shipping operations, Australian Paper has also secured efficiency gains at its Melbourne intermodal transfer through the development of Toll Shipping's 'Paper Gate.' Only vehicles with paper for AP and/or Norske Skog Australasia (NSA) are able to utilise this gate to enter and exit the terminal area. Further efficiency gains have been achieved through AP and NSA using a common transport service provider to move freight to its final destination.

---

[5] Clay is used as white pigment and coating material in the manufacture of paper.
[6] 2005/06 annualised estimate
[7] 2005/06 annualised estimate
[8] MAFI roll trailers, named after the German brand manufacturer, enable the pre-positioning of up to four containers on each 12+m trailer (stacked two high) which can then be loaded/unloaded onto/from vessels as a single unit improving task efficiency.

Australian Paper continuously reviews its supply chain logistics to seek efficiency improvements and cost savings. Under the current approach to the calculation and payment of assistance Australian Paper has not identified any instances where the freight task would be undertaken differently in the event that it had additional resources equivalent to TFES assistance. That is, there is no evidence of distortion of market behaviour.

> ***"Australian Paper's supply chain is optimised around minimum total cost, how we move it wouldn't change with different levels of TFES assistance, whether we move it would!"***
>
> Phillip Porter
> National Logistics Manager

However, marginal reductions in the level of TFES assistance would have significant impacts on supply chain efficiencies and costs through the potential loss of economies of scale and the varying impacts this would have at different points of the supply chain. E.g. there is a point at which the capital cost of maintaining a heavy lift capability for unloading containers will not offset the higher freight costs that might be incurred in using side-loading container trucks and/or non-containerised vehicles.

5. CALCULATION OF ASSISTANCE

The Tasmanian Freight Equalisation Scheme (TFES) provides assistance to shippers of eligible goods, transported by sea between Tasmania and the Australian mainland, with the aim of assisting *"… 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*."[9]

It is recognised that this comparative disadvantage is likely to change over time and in particular as:

– the relative transport efficiencies of road compared with sea transport change;

– the cost structures of road and sea transport change; and

– industry strives for performance improvements in how intermodal exchanges are undertaken.

That the environment is changing was recognised in the review of the Tasmanian Freight Equalisation Scheme undertaken by the Tasmanian Freight Equalisation Scheme Review Authority in 1998. Specifically the TFES Review Authority stated that *"… By reviewing and updating these key parameters as necessary, the scheme can continue to track sea freight cost disadvantage as it changes over time and thereby maintain its relevance*"[10] and explicitly recommended that "*Key parameters of the proposed scheme should be reviewed on an annual basis and updated as required."* This recommendation was picked up in the Ministerial Directions governing the Scheme's operation which identifies in section 26.1 that the *"… key assistance parameters …will be reviewed on an annual basis and changes made … where those parameters are considered to have materially changed…"*[11]

It concerns Australian Paper that there is no evidence that the key assistance parameters have been reviewed since the revised scheme was implemented in 1999, even if such a review resulted in them being maintained at their current levels. For such an annual review process to have integrity it needs to be undertaken in a regular and transparent manner.

[9] Department of Transport and Regional Services, Tasmanian Freight Equalisation Scheme, Purpose of the Scheme, www.dotars.gov.au/transprog/maritime/tfes.aspx
[10] Tasmanian Freight Equalisation Scheme Review Authority, Advisory Opinion, 1998, p.30
[11] Minister for Transport and Regional Services, Directions for the operation of the Tasmanian Freight Equalisation Scheme, April 2002 (updated August 2003) p.7

The Ministerial Directions identify the key parameters as:

(a) Road freight equivalent costs;

(b) Door to door adjustment;

(c) Fixed intermodal cost;

(d) Route Scaling factor adjustment; and

(e) Median notional wharf to wharf freight cost disadvantage.

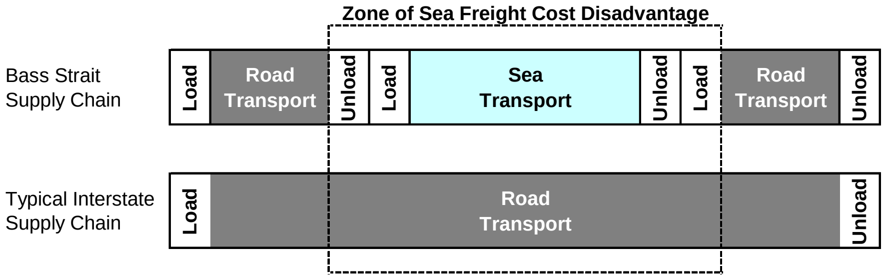
It is observed that the TFES Review Authority also identified as a key parameter "*the appropriate size and onset points of reductions in notional assistance entitlements to ensure incentives apply to minimise freight bills*" and this has been treated as an extension of item (e) above.

Australian Paper claims TFES assistance on a wharf-to-wharf basis between northern Tasmania and Victoria. As such it has no immediate comment to make on key parameters (b) and (d). In the following discussion, Australian Paper provides comments on the remaining parameters as they relate to its operations.

5.1 Road Freight Equivalent Costs

The Road Freight Equivalent is the base determinant of the sea freight cost disadvantage. In determining the relevant applicable rate, it is pertinent to review how this parameter is appropriately identified. Bass Strait shippers are required to undertake two additional intermodal interchanges when compared with an interstate mainland freight operation. This is illustrated in Figure 2 below.

Figure 2 - Comparison of conceptual supply chains for interstate freight movements



It is apparent that the appropriate measure for determining the Road Freight Equivalent is the marginal cost of transporting freight by road over a comparable distance which is equal to the wharf gate to wharf gate sea freight component.

Australian Paper operates two mills on the mainland located in Victoria (Maryvale) and New South Wales (Shoalhaven) that also produce a range of paper products. While the production of these mills differs from that emanating from Tasmania, the scale of the task and nature of the distribution network provides a sound basis for identifying the Road Freight Equivalent.

In the past eight years since the TFES Review Authority made its recommendations, there have been significant changes in the efficiencies with which land based interstate freight movements are undertaken. Specifically there has been the widespread adoption of higher productivity vehicles and the introduction of mass management schemes which return a productivity dividend for improved regulatory and safety compliance. In Australian Paper's case this has meant that the industry standard is now B-Double vehicles using air bag suspension with longer trailers and other design improvements that have allowed productivity improvements.

Australian Paper is currently negotiating new contractual arrangements that will see the 'standard' vehicle for its interstate freight movements being a B-Double tautliner with a payload of 45 tonnes. By comparison, productivity improvements in sea freight movements across Bass Strait are reflected in the standard use of customised containers[12] with a tare weight of 2.75 tonnes and a net weight of 17.12 tonnes; up from 15 tonnes at the time of the last major review.

- Australian Paper has investigated the cost of moving 17.12 tonnes (the TEU payload equivalent) over distances ranging from 299km to 888km which represents typical medium distance line haul rates that would reflect the nature of a hypothetical all road distribution network emanating from its Wesley Vale Mill. Using a series of 9 different routes and actual freight rates, Australian Paper was able to ascertain that the marginal km freight rate for moving a TEU equivalent 17.12 tonnes is $[redacted] c/km. This compares with a current TFES Road Freight Equivalent rate of $0.669c/km.

- That this calculated rate is comparatively so low is cause for concern to Australian Paper and substantiates its position that the historical levels of assistance provided have been too low.

- Australian Paper has also examined the port-to-port distance between the Port of Burnie and the Webb Dock terminal used by Toll. This distance, including allowances for the need to adhere to navigation channels, has been calculated as being only 406km.

- It is submitted that: a road freight equivalent cost of [redacted] should be used in the calculation of Australian Paper's notional wharf to wharf freight cost disadvantage.

5.2 *Fixed Intermodal Costs*

The basis of calculating assistance is the relative disadvantage of road versus sea over the distance that is Bass Strait. The Review Authority identified that the scope of the scheme needed to recognise *"… other presently undisclosed costs incurred in getting freight through the wharf gates …"* and elaborated that these undisclosed

[12] Australian Paper employs a dry container customised with smooth internal walls to minimise damage resulting from container movement.

costs include not only shipping consignment note costs, container hire and wharfage but other undisclosed costs incurred in getting freight through the wharf gates.

Australian Paper has investigated these undisclosed costs, summarised in Table 2 below, and determined that the current allowance for Fixed Intermodal Costs is inadequate to address this component of the sea freight cost disadvantage.

Table 2 – Average Fixed Intermodal Costs per TEU

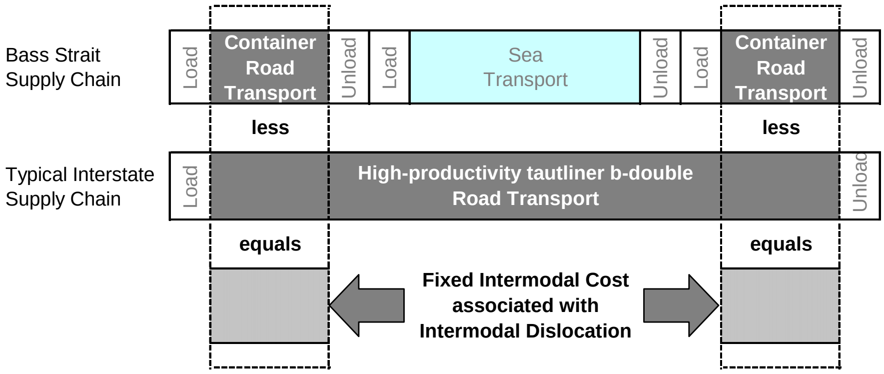
Fixed Intermodal Cost Component	**$ (excl GST)**
Intermodal Dislocation	$ 10.79
Additional Dwell	$ 12.96
Deconsolidation Costs	$ 104.35
Additional Equipment	$ 11.30
Total	**$ 139.40**

Source: Australian Paper, Internal Assessment, June 2006

5.2.1 Intermodal Dislocation

Intermodal dislocation manifests itself through the inability to operate a typical line-haul operation over the full length of the door-to-door delivery chain. Specifically, it is the additional costs incurred in needing to move product packaged (containerised) for efficient sea shipment over that which would have been incurred if higher productivity tautliner B-Double vehicle were used for this part of the supply chain. This concept is illustrated in Figure 3.

Figure 3 - Identification of Intermodal Dislocation



It is recognised that this intermodal dislocation is only incurred where product is moved in containers and under normal circumstances would be moved in tautliners or some other form of purpose built vehicle. It is recommended that a differential fixed intermodal cost be applied to product shipped in containers.

Australian Paper has quantified this cost as being $10.79

5.2.2 Additional Dwell

To move product by sea it is necessary to present freight in a timely fashion in order that it can be available at such time as stevedores commence loading. The notional cut-off point for presenting freight represents the point before which cargo must be lodged. In practical terms, for all shippers to ensure cargo is able to be appropriately marshalled and transferred to MAFI trailers for loading, it is necessary to present product over an extended period preceding the scheduled sailing.

In addition there are ever present risks that due to unforeseen demand and associated loading constraints, there is a need to have extra product in the supply chain to meet these risks.

Australian Paper has quantified these additional dwell costs as being $12.96

5.2.3 Deconsolidation Costs

For Australian Paper, minimising the total freight cost of the door-to-door supply translates into maximising product stowed in each container, and indirectly minimises the amount of TFES assistance claimed. Where a customer order represents less than a full container load (FCL) orders are aggregated to minimise transport costs.

However, such consolidation generates a commensurate requirement for deconsolidation prior to delivery.

Australian Paper has quantified these deconsolidation costs as being $104.35

5.2.4 Additional Equipment and Delivery Costs

In shipping product interstate between mainland origin/destinations, Australian Paper is able to make use of comparatively light weight equipment such as fork lifts and is able to use tautliner vehicles to effect delivery directly to its customers with minimal impact on their infrastructure requirements.

The requirement to transport freight across Bass Strait in containers imposes additional costs on Australian Paper. These costs are associated with the provision of heavy lift container fork lifts, heavy duty staging areas for containers prior to being filled/while awaiting collection for transport to the wharf and similar deconsolidation areas and equipment in Melbourne. Where containers are used direct to customer sites there are also additional costs associated with longer unload times and the need to provide additional truck capacity to accommodate the increased numbers of vehicles required to effect deliveries.

Australian Paper has quantified these additional costs as being $11.30

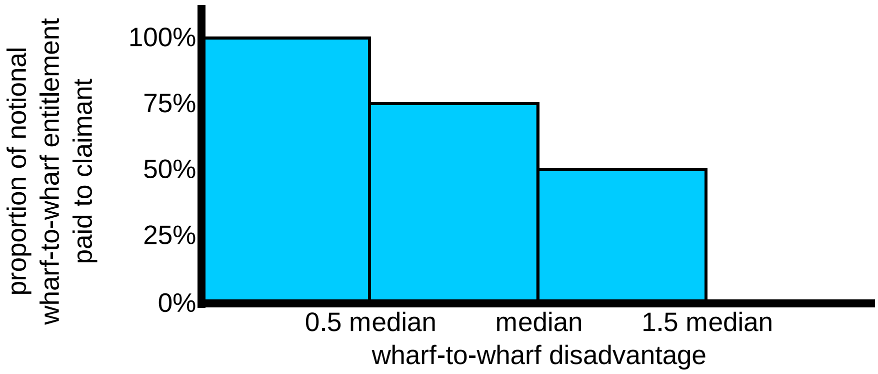
It is submitted that the Fixed Cost Intermodal component of Tasmanian Freight Equalisation Scheme assistance should be revised to $139.40

5.3 Median Notional Wharf-to-wharf Freight Cost Disadvantage

In its 1998 report, the TFES Review Authority recognised that "*the starting point for assistance is the calculation of wharf gate to wharf gate sea freight cost disadvantage. The difference between wharf gate to wharf gate costs and road freight equivalent defines this disadvantage and the notional entitlement to assistance*." It went on to identify that there was a 'basic incompatibility' between the notion of full compensation based on this disadvantage and incentives to reduce costs.

While Australian Paper recognises the need for incentives, this must be based on equitable consideration of the capacity to negotiate lower rates; i.e. that those securing very low freight rates have marginal capacity to negotiate reductions compared with those on higher rates. To some extent this notion has been captured in the declining rates of compensation associated with where an assistance claimant's disadvantage sits relative to the median level of disadvantage.

Figure 4 - Structure of the Tasmanian Freight Equalisation Scheme incentive mechanism



However, of acute concern to Australian Paper is that the recent Australian Government approved rationalisation of shipping service providers on Bass Strait (see section 6.1.3) will diminish Australian Paper's negotiating power with respect to maintaining low sea freight rates.

Specifically, Australian Paper requires a reliable daily shipping service for containerised product. The emerging reduction in competition brings with it scope for the single major containerised shipping service provider to exercise what is effectively monopoly power in the Bass Strait containerised freight market. By comparison smaller volume shippers and those moving freight in final destination vehicles (livestock, pantechnicons, etc.) generally incur higher freight rates on a per TEU basis, incur a higher wharf-to-wharf disadvantage and will continue to have an effective negotiating position courtesy of the TT-Line Spirit of Tasmania services.

Accordingly it is recommended that the proportion of notional wharf-to-wharf entitlement paid to claimants with a wharf-to-wharf disadvantage lying between 0.5 and 1.0 times the median wharf-to-wharf disadvantage be set at 85%.

6. ISSUES

6.1 Rationale for TFES

"*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*."[13]

The Tasmanian Freight Equalisation Scheme 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 in effect 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.

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, access to Tasmanian markets by mainland producers and the reciprocal access to mainland markets by Tasmanian producers would be severely compromised.

> ***"The evidence shows TFES is a targeted assistance program that delivers on its stated objective."***
>
> Simon Talbot
> Corporate Relationship Manager

The rationale for the Scheme's existence is as pertinent today as it was at the Scheme's inception. It is difficult to envisage a program that will target addressing the sea freight cost disadvantage incurred by Bass Strait shippers in a more effective manner.

However, it is observed 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. While Australian Paper applauds such investment, it is apparent that with respect to transport across Bass Strait these investments are having perverse impacts. These investments are improving the distribution efficiencies of importers in the Australian market and progressively eroding the competitive advantage of Australian production facilities located in Tasmania.

The impacts of some of these policies are highlighted below.

6.1.1 Investment in land transport

Through its significant direct investment in highways infrastructure, most recently using the AusLink program, the Commonwealth has provided evidence of the importance it places on regional and interstate transport linkages and its recognition of the role of

[13] Department of Transport and Regional Services, http://www.dotars.gov.au/transport/programs/maritime/tasmanian/index.aspx, 9 June 2006

transport in the economic development of the nation. AusLink is "… supported by a $15 billion program of Australian Government investment over the five year period 2004-05 to 2008-09 together with partnering funding from State and Territory Governments."[14]

Improved transport infrastructure, coupled with the development of national standards etc. for vehicle operations, has enabled land transport operators to make significant improvements in vehicle utilisation and productivity. These improvements have been reflected in rising vehicle payloads (better than 15% since the current TFES arrangements were introduced) and reduced transit times between major interstate destinations.

Australian Paper is not aware of any comparable infrastructure, regulatory or standards based investment by Australian Governments to deliver any performance gains for Bass Strait shipping.

6.1.2 Waterfront Reform

The Commonwealth Government has long recognised the importance of an efficient waterfront to Australia's economic performance. Significantly in 1998 it facilitated and supported significant restructuring of stevedoring activities through measures such as the funding mechanisms provided through the Stevedoring Levy and associated support.

One of the seven benchmark objectives targeted through the Commonwealth Government's reform agenda was improved productivity through a commitment by major stevedores to a benchmark of 25 lifts per hour as a national five port average. At the time the Commonwealth Government recognised that the performance of Bass Strait shipping operators already far exceeded the productivity benchmarks being set for the stevedoring sector. Consequently the Stevedoring Levy was not applied to Bass Strait container shipping operations.

> ***"While waterfront productivity improvements are in the nation's interest, they have worked against Tasmania's competitive position in the Australian marketplace."***
>
> Julian Mathers
> General Manager

It is also notable that stevedores agreed to absorb the Stevedoring Levy within their existing cost structures with the expectation that the productivity improvements and reduced cost structures would more than offset these costs and the Commonwealth Government directed the Australian Competition and Consumer Commission (ACCC) to monitor the sector in relation to the progress of the reforms.[15] In its November 2005 report[16] the

---

[14] Department of Transport and Regional Services, AusLink Home Page, http://www.auslink.gov.au/

[15] On 20 January 1999 the Federal Treasurer directed the ACCC to monitor prices, costs and profits of container terminal operators at the ports of Adelaide, Brisbane, Burnie, Fremantle, Melbourne and Sydney. The aim of the monitoring programs is to provide information to the Government and the wider community about the progress of waterfront reform at Australia's major container terminals. The monitoring program also provides information about the levy on the loading an unloading of containers and cars. The funds from this levy are used to ensure all

ACCC indicated that real costs have continued to decline and productivity continued to increase.

These Government supported reforms have had marginal impact on Bass Strait shipping operations but as with land transport infrastructure, investments have reduced the relative costs of importers to access Australian markets. It is pertinent to note that the Stevedoring Levy fully recovered the support payments made to Stevedores in May 2006. While only $12 per TEU, the removal of the Stevedoring Levy affords paper importers an opportunity to negotiate an advantageous position in an extremely tight market.

6.1.3 Shipping

Bass Strait shipping is currently characterised by the operation of two major cargo service providers, Toll and Patrick, with some additional limited scope for trailer freight being provided by TT-Line operated ferry services.

> ***"Relaxation of cabotage will not deliver the frequent, timely and cost effective services Australian Paper requires."***
>
> Phillip Porter
> National Logistics Manager

Structural reform of Australia's coastal shipping operations has been proposed on a number of occasions and it is observed that cabotage policies[17] have been eased. However, overseas vessels operating on Australian coastal routes do not provide the frequency and scale of service required by Australian Paper. Where intermittent use could be made of foreign flagged vessels, this would necessitate the establishment of a range of new access arrangements at Swanston Dock as this is the location where these vessels would berth. These additional costs would be compounded by the attendant loss of scale efficiencies at Webb Dock.

It remains that Bass Strait Shipping operates as an effective duopoly with higher cost structures than domestic shipping in many other countries.

> ***"Competition is essential to maintaining competitive freight rates. The Government endorsed rationalisation of major shipping service providers is cause for concern."***
>
> Phillip Porter
> National Logistics Manager

In August 2005 Toll Holdings Ltd announced its intention to acquire Patrick Corporation Ltd, including the latter's Bass Strait shipping operations. While initially opposed to the acquisition, the ACCC dropped action against Toll in March 2006 and accepted an offer of undertakings. This offer requires Toll to divest itself of Patrick's Bass Strait shipping operation. Pending the sale of the Patrick shipping interests it remains that the Commonwealth, through the ACCC, has endorsed the operation of a monopoly service provider for Bass Strait cargo shipping operations.

Australian Paper is particularly concerned that, as Toll gains an increased knowledge of its former competitor's operations, the capacity to divest this as a viable and

---

stevedoring employees made redundant as part of the Government's reforms strategy receive full redundancy entitlements.
[16] Australian Competition and Consumer Commission, Container Stevedoring Monitoring Report No,7, p.2, November 2005
[17] Reservation of a country's coastal (domestic) shipping for its own flag vessels

competitive shipping service will progressively diminish; ultimately leading to a situation where monopoly rents may be commanded.

It is apparent that notwithstanding the equity issues that underpin TFES's continuation, the Commonwealth has continued to support land based transport investment and policies that limit the capacity of Bass Strait supply chains to deliver in a competitive manner without assistance to offset the sea freight cost disadvantage.

6.2 TFES Performance

Australian Paper regards TFES as a focussed and highly targeted program that addresses a specific objective, "the reduction of the sea freight cost disadvantage", in a largely effective manner. That there is scope for improvement is apparent from the preceding discussion regarding the calculation of assistance. With changes in vehicle productivity and the infrastructure available to support interstate trade there will always be a continuing need to refine the scheme to ensure it continues to appropriately assist shippers who incur a sea freight cost disadvantage.

The following observations are made on the delivery of the TFES program.

6.2.1 Certainty

The key principle missing from those outlined in the Issues Paper is certainty. The TFES Review Authority defined this characteristic as "*Sufficient certainty so that shippers and carriers are not faced with unpredictable changes in the likely basis for, and level of, assistance in the medium term (four to five years)*. Consequent to this, the Review Authority recommended that the scheme have a rolling five year term and that its parameters be reviewed on an annual basis. Australian Paper regards shocks to the level of assistance as being counterproductive. While the impact of a downward shock is readily apparent, an upward shock, (while welcome at the time) actually indicates that in the preceding periods, enterprises will have had an inappropriate basis for making investment decisions and consequently opportunities will have been foregone or suboptimal outcomes pursued.

> ***"The rolling five year commitment to TFES is undermined by the absence of annual fine tuning of the parameters for calculating assistance. These are essential if the adverse impacts of periodic major step adjustments are to be avoided."***
>
> Matthew Fryett
> Commercial Manager - Tasmania

It is recommended that the clear commitment to a rolling five year funding program be supported by a transparent framework for adjusting the parameters. This would 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.

6.2.2 Administration

Australian Paper claims TFES assistance on a wharf-to-wharf basis. Claims for southbound freight are lodged with accompanying invoices to provide evidence of claims. For its northbound freight operations Australian Paper uses a paperless freight lodgement and invoicing system. By arrangement with CentreLink, claims for northbound assistance are lodged on the evidence of internally generated statements. The arrangement with CentreLink provides for independent annual auditing of Australian Paper's claims procedure.

> ***"Our experience is that the claim system works well and that the Hobart CentreLink Office understands the nature of our business and provides good service."***
>
> Matthew Fryett
> Commercial Manager - Tasmania

In all its dealings with CentreLink in relation to lodging claims, promptness with which these are paid and the occasional need to make adjustment (e.g. when Australian Paper is required to remit a refund for returned goods) the staff have always been helpful and accommodating.

It is recognised that whilst not significant in the context of Australian Paper's assistance claims, there are administrative overheads associated with the current requirement to provide physical evidence of invoiced amounts.

While there have been suggestions that an electronic claims lodgement system would reduce administrative overheads for both shippers and Government administrators such proposals will need to be evaluated on their merits at the time.

Australian Paper is comfortable with the simplicity of the current scheme.

6.2.3 Flat Rate of Assistance

The Productivity Commission queried the desirability of a "… *single dollar rate of subsidy per container, irrespective of a recipient's actual shipping costs.*" While it is apparent that such an approach will reduce administration costs current compliance costs are not regarded as onerous and must be weighed against the capacity a flat rate approach will have to address variations in the sea freight cost disadvantage that exists across Bass Strait shippers.

Specifically, it is unlikely that a flat rate assistance approach will endorse the overcompensation of any individual shipper. Consequently, by its nature, flat rate assistance would probably be aligned with the minimum level of sea freight cost disadvantage currently experienced by any Bass Strait shipper. As such, the level of <u>under</u>-assistance would escalate at the same rate, in dollar terms, as the notional sea freight cost disadvantage that is experienced.

On this basis a fixed rate approach is opposed as an alternative method for delivering assistance as it fails to recognise two key features embodied in the current scheme:

1. responsiveness to fluctuations in freight rates; and
2. the different levels of disadvantage faced by shippers.

That is not to say that there may not be scope for some application of a flat rate assistance approach as a supplementary alternative for those shippers who find the current approach administratively onerous.

6.2.4 Rorting

Australian Paper has no evidence of any rorting. However, allegations of abuse of the scheme are damaging to its integrity and measures to ensure compliance with the moral intent of the scheme will, subject to an impact assessment, be strongly supported.

Without knowledge of how, why and where suspected rorting has occurred Australian Paper is poorly equipped to provide suggestions as to how the potential for such abuses might be reduced.

6.3 Eligible Goods

It is noted that this Productivity Commission review of Tasmanian freight assistance arrangement is concurrently examining the Tasmanian Freight Equalisation Scheme and the Tasmanian Wheat Freight Scheme. It is understood that the concurrent consideration of the schemes in this review is in part attributable to what is regarded in some circles as the distortion effects of TFES assistance for containerised grain movements on the volumes of bulk grain being moved.

While recognising that there has been a distortion, Australian Paper regards this less as being attributable to the provision of assistance on containerised wheat, rather it is because of an absence of appropriate assistance on mini-bulk wheat shipments. It has been suggested that if given an option between a shipping service and a bulk road or rail operation over the same distance, a shipper would probably elect to take road or rail.

Arguably if all mini-bulk movements were assisted on the same basis as TFES freight, (the difference between actual sea freight costs and how the product might best be moved over a comparable land distance) then the competitive relativities between the modes would be re-established.

In such an environment Australian Paper would be inclined to explore the potential for moving selected inputs by mini-bulk shipment.

6.4 Uncertainties Associated with the Review Process

In its 1998 report the Tasmanian Freight Equalisation Scheme Review Authority emphasised "*…the need for a scheme whereby assistance responds readily to changed cost conditions facing Tasmanian shippers. Such a 'live' scheme would be sensitive to any gains to shippers from waterfront reform, an end to cabotage and the like. To provide the required investment certainty for shippers and transport operators, it is appropriate to announce each year whether the scheme will be retained beyond a five year horizon from that date. It is also necessary to review and where significant change has occurred, adjust key parameters on an annual basis if the scheme is to remain a 'live' scheme.*"

It is concerning to Australian Paper that the Ministerial Directions governing the operation of the Scheme and which set the assistance parameters have not been updated since August 2003 and that this update did not actually address the parameter values.

We are very concerned at the politics of the current situation and in particular rumours/suggestions that the Federal Government will:

- Seek to reduce overall TFES payments to industry;
- Seek to hand responsibility for TFES to the Tasmanian Government; or
- Seek to roll TFES into other transport arrangements such as AusLink and Pacific National assistance.

Such rumours engender uncertainty in the business community and have the capacity to manifest in a reluctance to undertake investment in an environment where there is trepidation regarding the underlying agenda. Consistent with the recommendations of the TFES Review Authority, Australian Paper strongly advocates annual review and, if needed, incremental adjustments to all parameters to alleviate the potential for major step adjustments in assistance provided under TFES.

We appreciate that the Productivity Commission sees itself as independent of Government, but major reviews can result in other parties taking the results and selectively using them to push for the scheme to be downgraded or abolished. Naturally, we will be encouraging Government at all levels to ensure a “big picture” approach and to make sure they look at the full economic benefits that the scheme has delivered and continues to provide.

7. CONCLUSION

The Tasmanian Freight Equalisation Scheme is as relevant today, if not more relevant, as the day it was first implemented. In an environment that has seen the emergence of highly competitive global markets and a focus on productivity and performance improvement for Australian land transport networks, TFES is crucial to the equitable participation of Australian Paper in the Australian sector of the global paper market.

Without TFES Australian Paper's Tasmanian operations would be unsustainable. Accordingly, the value Australia derives from ensuring equitable participation of Tasmania in the national market, and more specifically Australian Paper's Burnie and Wesley Vale Mills, can be summarised as:

- A $1.1 billion positive impact on foreign trade (based on the present value of current results extended over 10 years);
- 2,400+ full time equivalent jobs (conservative estimate); and
- A government revenue dividend 6.5 times the $6.2m provided to partially alleviate the sea freight cost disadvantage.

However, while the assistance provided supports the retention of these benefits the full benefit capacity of TFES is unknown. TFES assistance parameters have not been reviewed on an annual basis as directed in the Minister's Directions governing the Scheme and consequently equitable assistance is not forthcoming. Specifically:

- The road freight equivalent rate is currently too high, understating the notional disadvantage and reducing assistance payments accordingly;
- The Fixed Cost disadvantage component of assistance payments is set too low and does not fully address the intermodal cost disadvantages incurred; and
- Incentive mechanisms fail to recognise the changing structure and competitiveness of Bass Strait shipping service providers.

The highly targeted nature of TFES and the basis on which assistance is calculated are considered two of the schemes main strengths. Proposals and suggestions targeting lower compliance/claiming costs, simplifying the assistance calculation process and alternative delivery mechanisms would only be supported on the basis that the underlying sea freight cost disadvantage is more equitably addressed.

Responses to issues such as rorting and a broadening of the eligibility criteria would need to be addressed on case-by-case basis to specific proposals.