

Response to Productivity Commission's
Issues Paper on Tasmanian Freight Subsidy
Arrangements (April 2006)

Submission By

VICTORIAN GOVERNMENT

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Executive Summary

The Victorian Government is pleased to respond to the Productivity Commission's *Issues Paper* "Tasmanian Freight Subsidy Arrangements". Overall, the Victorian Government supports the continuation of both the Tasmanian Freight Equalisation Scheme (TFES) and the Tasmanian Wheat Freight Subsidy Scheme (TWFSS). However, in addition to some improvements to current arrangements, the Victorian Government suggests that the Commission consider the possibility of extending the TFES to final goods in the southbound direction.

The size of Bass Strait trade was approximately 6.5 million revenue tonnes, or just over 220,000 TEUs in 2004/05.¹ In relative terms, this trade forms a substantial freight corridor, being significantly larger than the Melbourne-Brisbane route and less than a million tonnes smaller than the Sydney-Brisbane route over the corresponding period.

The effectiveness of the current arrangements

The aim of the TFES, as outlined in the Minister for Transport and Regional Services' Directions² (the TFES Directions), is:

"to assist in alleviating the sea freight cost disadvantage incurred by the shippers of eligible non-bulk goods moved between the mainland and Tasmania by sea".

On the other hand, the Department of Transport and Regional Services (DOTARS) website states that:

"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".

The Commission describes this as "a more fundamental regional development goal"³, attempting to promote "greater equity of economic outcomes across Australia"⁴

The Victorian Government believes that there is currently some uncertainty as to the precise objectives of the TFES. If the scheme is, in

¹ Bulk freight is generally not transported in shipping containers.

² Directions by the Minister for Transport and Regional Services, For the operation of the Tasmanian Freight Equalisation Scheme

³ Ibid, p. 7

⁴ Ibid

fact, intended to have a broader objective, as a matter of sound public policy, this ought to be reflected more explicitly in the aims outlined in the Minister's Directions.

If it is agreed that there is an underlying regional economic development objective behind the TFES, it will also be important to assess, as with any subsidy or taxation policy, the likely aggregate economy wide impacts as well as the specific incidence of impacts.

The Tasmanian economy should benefit from higher economic production resulting from subsidised access to larger domestic markets in mainland States. Industries which receive the majority of subsidies are vegetables, mining and manufacturing, wood and paper industries, as well as food and beverages.

Tasmania's economy has enjoyed strong economic growth of 4.5 per cent per annum since 2000/01 with unemployment falling to 6.1 per cent. Whilst the influence of the TFES may appear to be relatively moderate, the relevant beneficiary industries appear to be in robust health, financially viable and important economic contributors to Tasmania.

Victoria and other States are likely to benefit to the extent that any industries are able to increase levels of production due to the subsidy provided on southbound inputs into Tasmanian industries. In addition, mainland wheat producers benefit from the TWFSS by exporting higher volumes of wheat to Tasmania.

It is understood that the Productivity Commission has outsourced general equilibrium modelling – to be conducted by the Centre of Policy Studies (CoPS) – for the purposes of quantifying these impacts. The Victorian Government supports this approach.

Incentive & administrative issues

Under the current design of the scheme there is likely to be at least some scope for “gaming” by industry participants. The provision for TFES subsidies to be calculated based on actual door to door (bundled) freight costs can result in higher than intended subsidies being paid. As a result, the scheme is likely to be inadvertently subsidising some land freight costs.

The current scheme may also have the effect of weakening incentives to minimize ‘wharf to wharf’ freight costs within particular cost ranges. In particular, if any shipper were able to achieve a standard TEU wharf-to-wharf price of \$615.50 (\$335.50 + \$281) or less in a free market, in the

subsidized market they would have no incentive to further reduce the price with the shipping company, as at that price point they are receiving a 100 percent subsidy. This circumstance would provide the shipping company with what equates to a regulated “price floor”.

One possible means of addressing the unintended effect of subsidising land freight and other non ‘wharf to wharf disadvantage’ costs, may be to modify the subsidy to a **flat per TEU rate**, although the Victorian Government is aware that this potential change may also raise some equity arguments.

In relation to administration of the schemes it is noted that claims submitted as long as two years after the date of shipment are accepted. This raises issues around accurate data collection, reporting and possible incentives to delay claims.

It is also considered that there should be greater transparency around annual parameter reviews for the TFES scheme.

Applying TFES to southbound final goods

The AusLink national transport program is concerned with facilitating transport connectivity, equity and trade across the nation. Despite the relative magnitude of the Bass Strait freight task, and its significance nationally, Bass Strait has not been included as part of the AusLink network, as it is not land based.

The Victorian Government notes, however, that AusLink objectives clearly overlap with the goals being pursued through the Tasmanian freight subsidy schemes, particularly in the area of encouraging improved freight transport connectivity. Broader national transport objectives might therefore sensibly be pursued concurrently through both AusLink and the sea-freight subsidy schemes.

The Victorian Government suggests that the most effective and equitable way to align the TFES and AusLink policies would be to extend the subsidy to final goods in the southbound direction.

It is, therefore, recommended that the Commission explore the implications of extending the TFES to include final goods in the southbound direction.

1. Introduction

The Victorian Government is pleased to respond to the Productivity Commission's *Issues Paper* "Tasmanian Freight Subsidy Arrangements" which addresses both the Tasmanian Freight Equalisation Scheme (TFES) and the Tasmanian Wheat Freight Subsidy Scheme (TWFSS).

The primary focus of this submission is the design and implementation of the TFES, due to its relative size and importance to the Tasmanian economy.

The Victorian Government is responding because it considers the schemes to be important to the economic development of Tasmania, which is in turn important to Victoria and the nation more generally. In making the submission some suggested improvements to the TFES scheme, aimed at enhancing its effectiveness, are presented for the consideration of the Commission.

Overall, the Victorian Government supports the continuation of both schemes to offset the freight cost disadvantage faced by Tasmania when compared with the mainland states.

However, the Victorian Government also suggests that the Commission consider the significance of the Bass Strait freight corridor in the context of the Australian Government's AusLink transport objectives by exploring the extension of the TFES to final goods in the southbound direction.

The Victorian Government believes that extending the TFES to southbound final goods would enhance synergies between two separate, but clearly related, national policies and thereby enhance transport connectivity, economic competitiveness and regional equity across Australia.

Specifically, extending the scheme in the southbound direction would provide Tasmanian consumers with access to final goods at similar prices to mainland consumers and would neutralise any distortions in the allocation and use of resources in Tasmania arising from the current scheme's emphasis on northbound freight.

The following section of this submission briefly outlines the Victorian Government's understanding of the operation of the schemes. Section three comments on the effectiveness of the current arrangements. Sections four and five suggest possible improvements to the operation and overall design respectively.

2. Operation of the schemes

TFES

The TFES was introduced in 1976 and was reviewed in 1985 and 1998. In particular, following the 1998 review, various changes were made to the scheme including changes to the list of eligible northbound products (eg. newsprint), as well as the introduction of annual reviews of subsidy parameters.

The TFES applies to non-bulk containerised sea freight between Tasmania and mainland Australia. In the northbound direction it applies to a fixed category⁵ of goods produced or manufactured in Tasmania, which are for permanent use or sale on the mainland. In the southbound direction it applies to raw materials or inputs produced or manufactured on the mainland for use in the mining and manufacturing industries as well as primary industries such as agriculture, forestry and fishing. There are also some special categories for sportspersons competing for prize money in a sporting event, professional entertainers and horse breeders.

The specific operation of the TFES is outlined in the *Directions by the Minister for Transport and Regional Development for the Operation of the Tasmanian Freight Equalisation Scheme* (the Minister's Directions).

Under the Minister's Directions, the subsidy is calculated on the basis of a standard 6.1 metre container, also known as a twenty-foot equivalent unit (TEU), of eligible standard weight goods shipped between northern Tasmania and Victoria (and the other direction). The *freight cost disadvantage* is then essentially calculated on the basis of actual sea freight costs incurred less the road freight cost equivalent.

There are two aspects of *freight cost disadvantage* that are subsidised under the scheme.

The first component is the *wharf-to-wharf (blue water)* freight cost of shipping. Under the scheme the amount of the subsidy applying to this component depends on the *notional wharf to wharf disadvantage* (NWW) incurred by the shipper. The NWW is calculated by subtracting the *road freight equivalent costs* (RFE) from the wharf-to-wharf freight cost incurred by the shipper. The RFE is currently set at \$281 for dry cargo and \$309 for reefer cargo and represents the average cost of transporting a TEU by road over a distance equivalent to that between northern Tasmania and Victoria (approximately 420km).

⁵ See Schedule 1, Directions by the Minister for Transport and Regional Services for the Operation of the Tasmanian Freight Equalisation Scheme

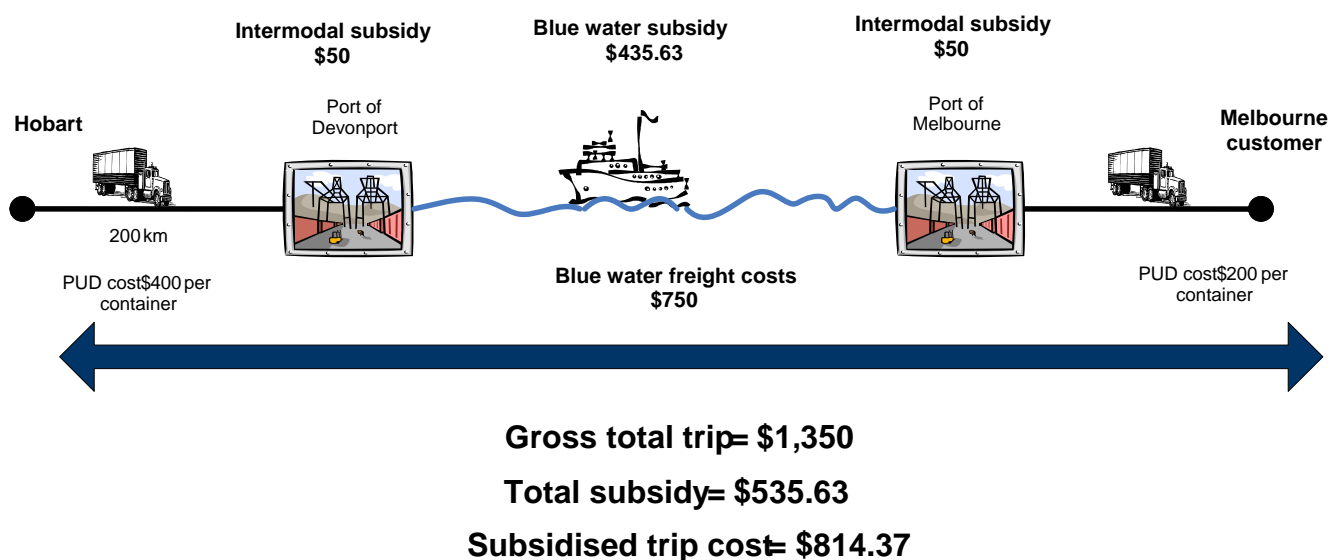
Once the NWW has been determined the blue water subsidy can be calculated. NWW costs up to \$335.50 per TEU are fully subsidized; amounts from \$335.51 to \$671 per TEU are subsidized at the marginal rate of 75 percent; amounts between \$671.01 and \$1,006.50 per TEU are subsidized at the marginal rate of 50 percent; while amounts above \$1006.51 per TEU are not subsidised.

Hence, for example, a standard weight TEU container shipped between Northern Tasmania and Victoria at a wharf-to-wharf cost of \$750 attracts a subsidy of \$435.63 per TEU.

The second subsidised component is the unavoidable *intermodal* cost incurred as a result of the need to transfer sea freight to road or rail at each end of the sea leg. Under the scheme there is a *fixed* amount that is subsidised for the intermodal cost which applies irrespective of the actual costs incurred. At the current time this amount is \$50 per TEU at each end of transportation, meaning that the total fixed intermodal subsidy is \$100 per standard weight TEU. This would take the total subsidy payable on the above example to \$535.63 per TEU.

The example in Figure 1 below demonstrates how the TFES reduces the freight costs Bass Strait shippers face.

Figure 1 **The role of the TFES in the Bass Strait freight trade**



In practice, however, various other adjustments are often required to calculate the subsidy. The methodologies for making these adjustments are also outlined in the Minister's Directions. For example, adjustments may be required for:

- **size of container**, for goods shipped in larger containers or trailers rather than a standard TEU;
- **distance**, for goods shipped on routes longer than the approximately 420 kilometres between Northern Tasmania and Victoria (called the scaling factor adjustment);
- **weight**, for high density or heavy cargo (called heavy weight assistance). Marginal weight is subsidized at 60 percent of standard TEU subsidy⁶;
- **land freight**, for any door to wharf and/or wharf to door component of the total freight bill (called the door to door adjustment).

More extensive examples which require the making of adjustments are outlined in the Attachment to the TFES Directions. The key assistance parameters are reviewed annually and changes may be made to the Directions if they “are considered to have materially changed”⁷.

The scheme is officially administered by DOTARS. Under the TFES Directions, the Minister (or Secretary) may make arrangements with third party organisations to assist with the administration of the scheme.⁸ The Victorian Government understands that the Tasmanian Assistance Services, Centrelink, is currently assisting with administration.

TWFSS

The TWFSS was reintroduced effective from July 1, 2004.

The TWFSS subsidy is a flat rate subsidy of \$20.65 per tonne for bulk wheat shipped (subject to the subsidy paid not being greater than the actual cost of shipments incurred by the shipper).

Claims for TWFSS subsidies must be made within 90 days of the date of shipment, or a longer period as approved by the Secretary.⁹

⁶ Hence, at the margin, the effective subsidy is 60 percent of either 100, 75, 50 or zero percent.

⁷ Clause 26.1

⁸ Clause 6.3

⁹ Clause 3.2 (f)

The TWFFS is currently capped at a total of \$1.05 million p.a.¹⁰ This amount is reviewed annually by the Minister.¹¹ As the financial allocation for subsidies is capped, they are only paid if the annual budget has not already been allocated in a given financial year.¹² In this latter event the subsidy may, if possible, be paid in the following financial year.¹³

As for the TFES, the Victorian Government understands that the Tasmanian Assistance Services, Centrelink, is currently assisting DOTARS with administration.

Summary statistics ¹⁴

Growth of TFES subsidy

Following the introduction of the TFES in 1976 the total subsidy amount for the scheme grew from \$16.4 million in 1976-77 to \$41.8 million in 1998-99. After adjusting for inflation, however, it is clear that the total amount of the subsidy in this timeframe experienced a real decline in aggregate terms.

Following the 1998 Review of TFES, significant changes to the Scheme's operation were implemented, notably to include newsprint as a category of product qualifying for TFES subsidy in the northbound direction.

Chart 1 illustrates the levels of total real TFES subsidy since the last review was undertaken in 1998. The levels of subsidy are reported in 2005 million AUD.

¹⁰ Clause 2.2

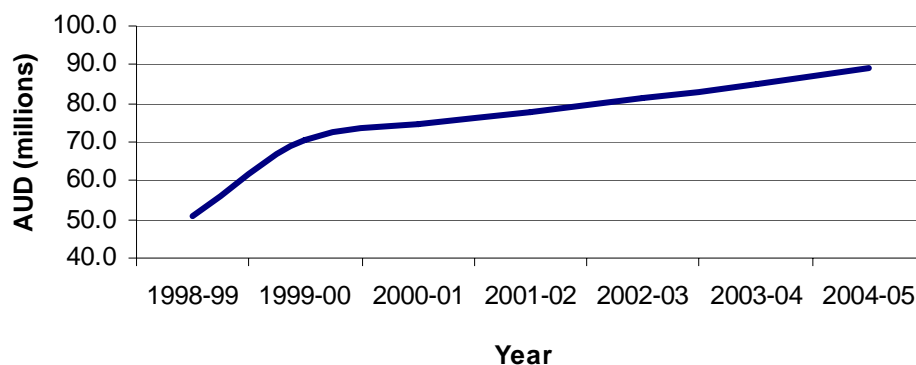
¹¹ Clause 6.1

¹² Clause 2.3

¹³ Clause 2.4

¹⁴ It is appreciated that there may be some issues surrounding the degree of reliance that should be placed on publicly available data for the TFES. For example, it is understood that there is currently an administrative aspect of the scheme that allows claiming of the subsidy anytime up to 2 years following the incurrence of Bass Strait shipping costs. This has the effect that there is a delay in relevant information collection regarding levels of subsidies. It also means the publicly available data reflects the year in which the subsidy is claimed (and payable by the Government) as opposed to the year in which the cost being subsidised is being incurred by the relevant freighting company. Nevertheless, reliance has been placed on the publicly available data for the purposes of this submission.

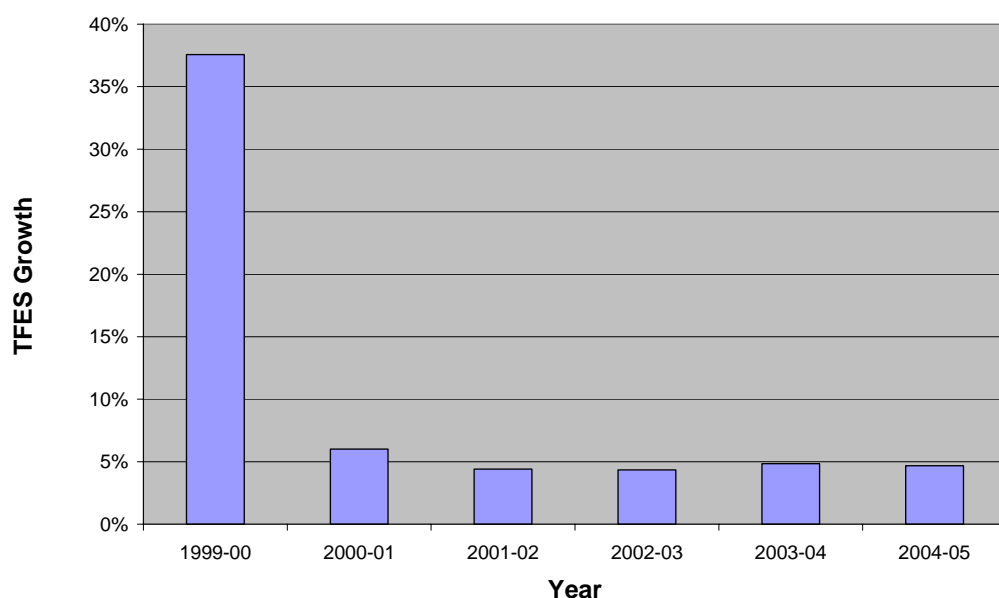
Chart 1 **TFES Real Program Expenditure**



Data source: Centrelink, Tasmanian Freight Equalisation Scheme Statistics, ABS CPI Data.

Figure 2 further illustrates the growth in real TFES subsidy levels. This figure demonstrates that whilst there has been significant nominal growth in TFES subsidy – particularly after accounting for the one off adjustment following the changes to the operation of the scheme in 1998 – the real level of subsidy growth since then has been steady at around 5 percent per annum.

Figure 2 **TFES annual growth rate from 1999/00 to 2004/05**



Data source: Centrelink, Tasmanian Freight Equalisation Scheme Statistics, ABS CPI Data

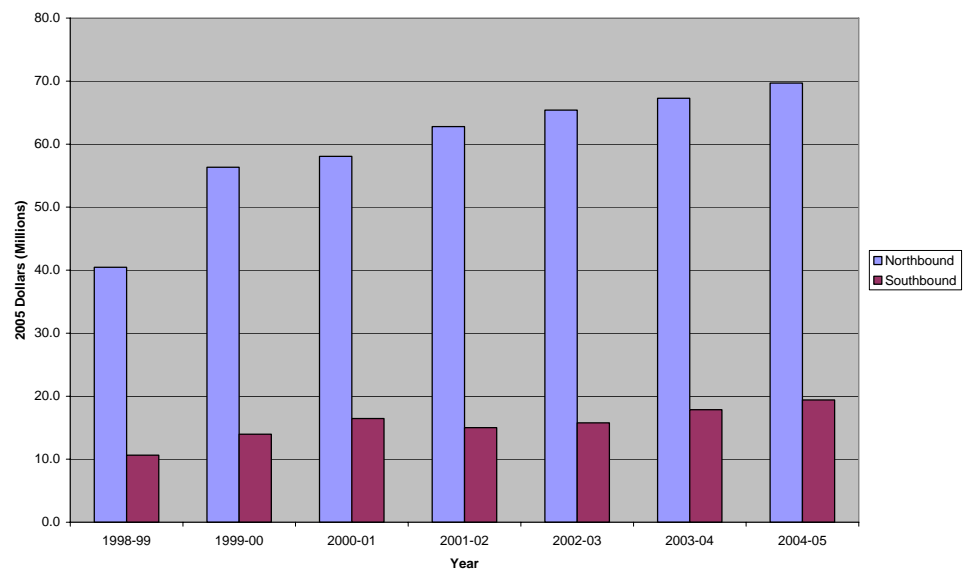
Analysis of volume (tonnage) growth over the past four years does not indicate any clear discernable trend. Similarly, the door-to-door prices represented in Centrelink data do not demonstrate any clear trend in median (or average) prices.

Without access to raw data sets, it is difficult to ascertain what is driving the current level of approximately five percent real subsidy growth.

Application of TFES subsidy by direction of trade

Figure 3 below clearly demonstrates the extent to which northbound freight dominates over southbound freight in attracting subsidies under the TFES.

Figure 3 **TFES Real Program Expenditure by Direction**

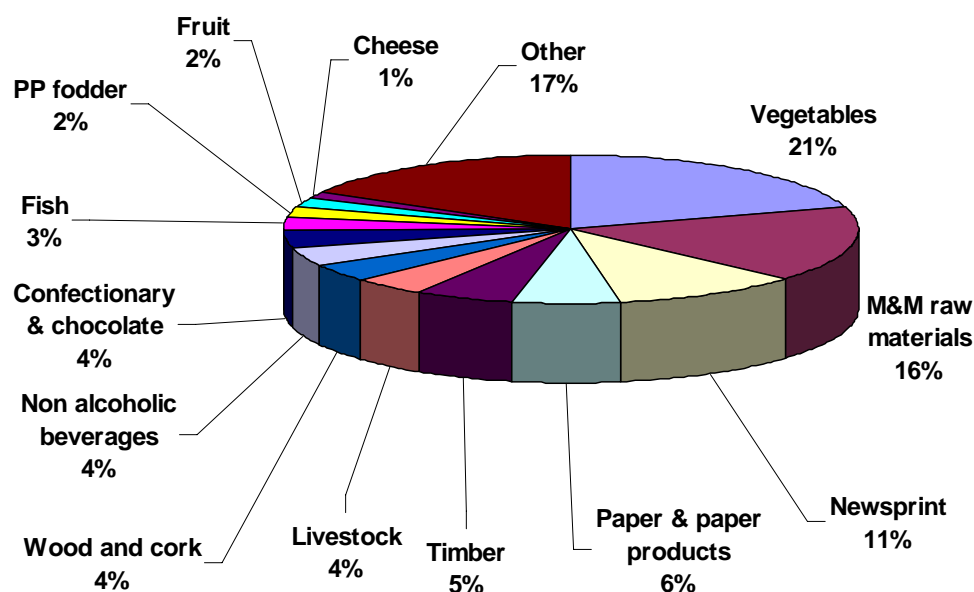


^a Data source: Centrelink Tasmanian Freight Equalisation Scheme Statistics, 12 months ending June 2005

Commodities

The following chart outlines the breakdown of the TFES subsidy by product category. These product categories have been determined by aggregating relevant Centrelink data. The chart does not distinguish between subsidies applied in the north and southbound directions.

Chart 2 **TFES Subsidy in 2004-5 by Product Groupings**



a Data source: Centrelink, Tasmanian Freight Equalisation Scheme Statistics, 12 months ending 30 June 2005

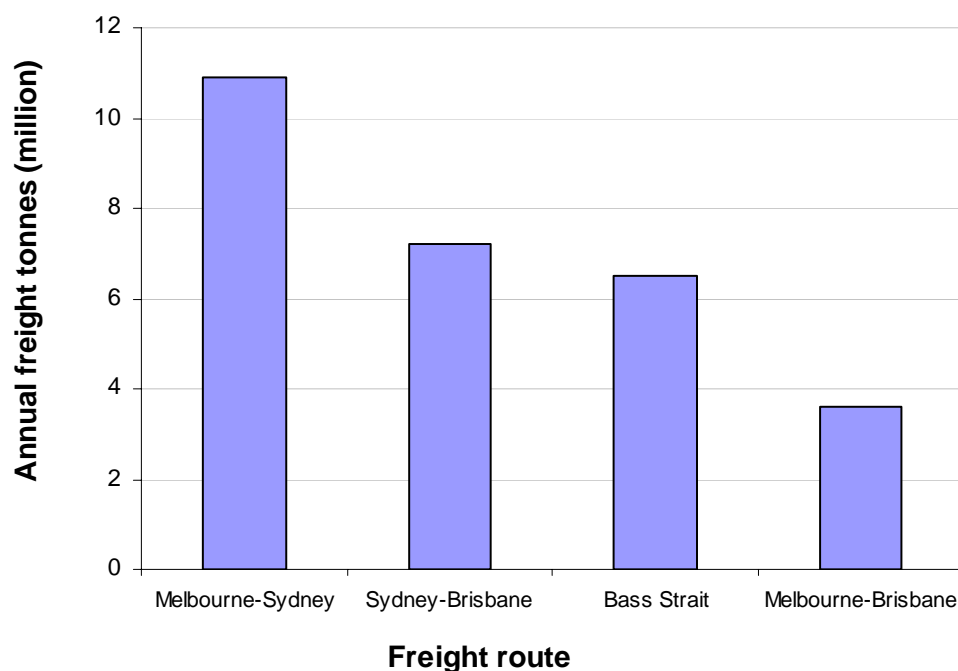
Total trade flows between Tasmania and the Port of Melbourne

The size of Bass Strait trade was approximately 6.5 million revenue tonnes, or just over 220,000 TEUs in 2004/05.¹⁵ In relative terms, this trade forms a substantial freight corridor, being significantly larger than the Melbourne-Brisbane route and less than a million tonnes smaller than the Sydney-Brisbane route over the corresponding period. The relative sizes of the major eastern seaboard freight movements are shown in Chart 3.

The relative magnitude of the Bass Strait freight task reinforces the Victorian Government's view, contained in its submission of February 2003 in response to the AusLink Green Paper, that Bass Strait is a freight corridor of national significance.

¹⁵ Bulk freight is generally not transported in shipping containers.

Chart 3 **Freight volumes by route in 2004/05**



Data source: Bureau of Transport Economics, Information Sheet 22 & The Port of Melbourne Corporation

The trade between northern Tasmanian ports and Melbourne is evenly balanced. Approximately 112,000 TEUs were transported north from Tasmania through the Port of Melbourne in 2004/05. In the other direction, 110,000 TEUs left Melbourne for northern Tasmanian ports over the same period. The corresponding revenue tonnes in each direction across Bass Strait were 3.2 million northbound and 3.3 million southbound. These figures are shown in Table 1.

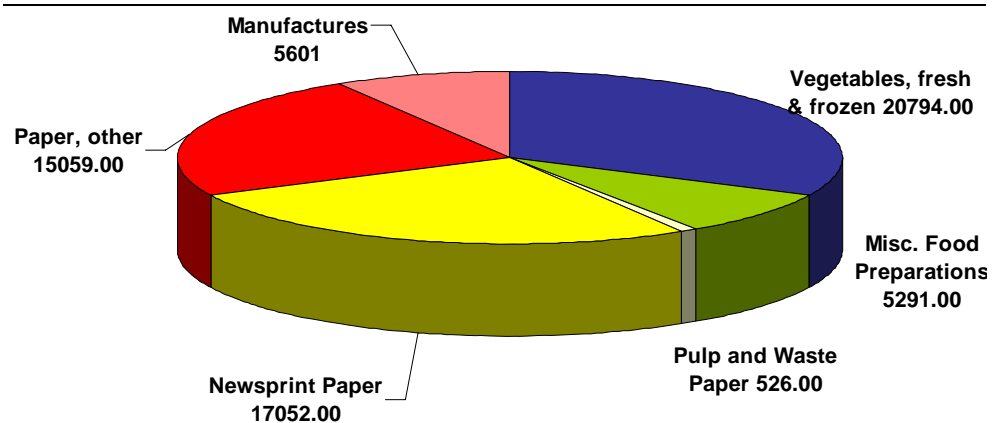
Table 1 **Melbourne-Tasmania freight flows for 2004/05**

	Northbound	Southbound	Total
TEUs	111,909	110,389	222,298
Revenue tonnes	3.197m	3.282m	6.48m

Data source: Port of Melbourne

The composition of total trade flows from Tasmania to the Port of Melbourne is outlined in Chart 4.

Chart 4 **Composition of northbound freight from Tasmania to the Port of Melbourne, 2004/05**



Note: Commodities with small freight volumes have been omitted from this chart.

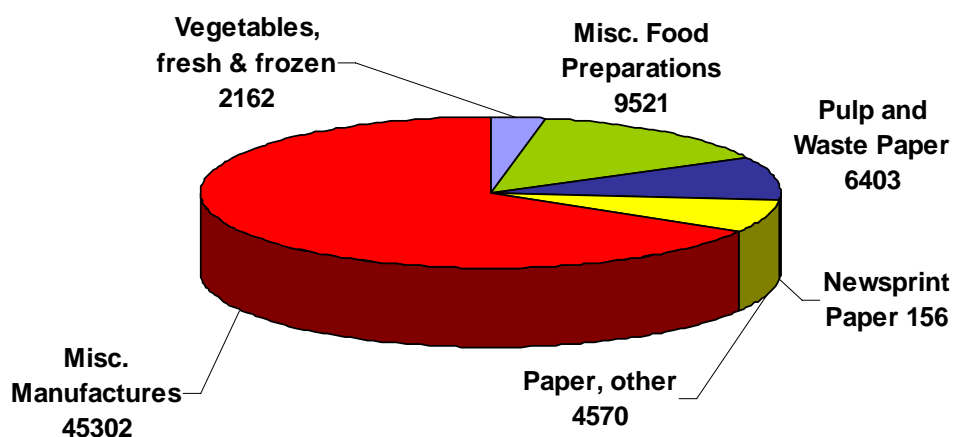
Data source: Port of Melbourne

The three dominant commodities being exported from Tasmania to the mainland or internationally are:

- fresh and frozen vegetables;
- newsprint; and
- paper.

Chart 5 outlines the composition of freight transported to Tasmania from the Port of Melbourne in 2004/05.

Chart 5 **Composition of southbound freight to Tasmania from the Port of Melbourne, 2004/05**



Note: Commodities with small freight volumes have been omitted from this chart.

Data source: Port of Melbourne

The dominant commodities being imported to Tasmania from the mainland are miscellaneous or intermediate manufactured goods to be used in the production of final goods in Tasmania. Intermediate goods, unlike final goods, are covered by the TFES in the southbound direction. Miscellaneous food preparations and pulp and waste paper are the next largest freight items flowing south from Melbourne.

3. The effectiveness of the current arrangements

Objectives of the Schemes

Before examining the effectiveness of the current arrangements, it is first necessary to clarify the objectives of the schemes.

The aim of the TFES, as outlined in the Minister for Transport and Regional Services' directions¹⁶ (the TFES Directions), is:

“to assist in alleviating the sea freight cost disadvantage incurred by the shippers of eligible non-bulk goods moved between the mainland and Tasmania by sea”.

This aim is reflected in, and wholly consistent with, paragraph 1 of the Terms of Reference for the review.

On the other hand, the Commission in its Issues Paper describes this as the “narrow purpose”¹⁷ of the scheme. The Commission notes that the Department of Transport and Regional Services (DOTARS) website states that:

“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”.

The Commission describes this as “a more fundamental regional development goal”¹⁸, attempting to promote “greater equity of economic outcomes across Australia”¹⁹

The purpose of the TWFSS, under the Minister for Transport and Regional Services' Directions²⁰ is “to subsidise the cost of bulk shipments of wheat from the mainland to Tasmania by sea”.

The DOTARS website states that the objective of the TWFSS is:

¹⁶ Directions by the Minister for Transport and Regional Services, For the operation of the Tasmanian Freight Equalisation Scheme

¹⁷ Productivity Commission, *Tasmanian Freight Subsidy Arrangements*, Productivity Commission Issues Paper, April 2006, p 6

¹⁸ Ibid, p. 7

¹⁹ Ibid

²⁰ Department of Transport and Regional Services, *Tasmanian Wheat Freight Scheme, Ministerial Directions*, 7 June 2005.

“To assist in alleviating sea freight costs of shipping eligible bulk wheat on Bass Strait so that businesses in Tasmania relying on bulk wheat shipments are not unduly disadvantaged.”

The Victorian Government believes that there is currently some uncertainty as to the precise objectives of the TFES. If the scheme is, in fact, intended to have the broader objective suggested by the Productivity Commission, then, as a matter of sound public policy, this ought to be reflected more explicitly in the aims outlined in the Minister’s Directions.

Moreover, it would be important to clarify what is meant by “regional development” and “equity of economic outcomes” to avoid any uncertainty and to explain how the scheme aims to deliver these.

If it is agreed that there is an underlying regional economic development objective behind the TFES, it will also be important to assess, as with any subsidy or taxation policy, the likely aggregate economy wide impacts as well as the specific incidence of impacts.

In this context it will be important to address the benefits to the economic development of Tasmania, relative to the total cost to the Australian economy, in the form of allocative, productive and dynamic efficiency losses. This process will involve looking at both direct and indirect impacts of the subsidy and would ideally incorporate transparent general equilibrium modelling.

A relevant aspect of such an evaluation will be to also examine the extent and incidence of impacts on other States (such as Victoria), including economy wide impacts as well as specific impacts on industries and consumers.

Impact on Tasmania

At an aggregate level, the Tasmanian economy should benefit from higher economic production resulting from subsidised access to larger domestic markets in mainland States.

The Tasmanian economy will also benefit indirectly through increased levels of consumption by those employed in industries in Tasmania which receive the TFES, as well as any investment (or reinvestment of profits) into Tasmanian industries.²¹

²¹ Tasmanian industries are likely to have some level of foreign ownership meaning that at least some of the value of increased production will be unlikely to accrue to the Tasmanian economy. This will be a relevant factor to consider in formulating the relevant assumptions for any general equilibrium modelling undertaken by the Commission.

Tasmania is also likely to receive additional social benefits from higher levels of employment and production, although these intangible benefits are unlikely to be quantifiable.

Various industries in Tasmania benefit directly from the schemes. Industries which receive the majority of subsidies are vegetables, mining and manufacturing, wood and paper industries, as well as food and beverages.

The TFES will benefit the operators (and of more relevance to Tasmania, the employees) of sea freight companies operating via Bass Strait due to increased volumes, as well as increased prices to the extent the subsidy results in this. These operators, however, are not Tasmanian companies.

Benefits will also extend to the operators of the Tasmanian ports – the three northern ports of Burnie, Devonport and Bell Bay will benefit to a greater extent than the southern port of Hobart – as well as freight forwarders and road and rail transport operators in Tasmania.

Tasmania's economy has enjoyed strong economic growth of 4.5 per cent per annum since 2000/01 with unemployment falling to 6.1 per cent. The influence of the TFES on this recent upturn in the Tasmanian economy may appear to be relatively moderate, but the relevant beneficiary industries appear to be in robust health, financially viable and important economic contributors to Tasmania. The TFES is likely to be contributing to this underlying industry growth, which in turn appears to be enhancing the overall health of the Tasmanian economy.

Attachment A - *A Case Study: the vegetable industry*, contains an analysis of the impact of the TFES on one significant Tasmanian industry.

Impacts on Victoria (and other States)

Whilst airfreight services play a role between Tasmania and the mainland, for most goods the Port of Melbourne operates as the major transport link between Tasmania and mainland Australia.

The Port of Melbourne handled 1.9 million TEUs and significant volumes of bulk freight in 2004/05. Of the port's total throughput, Melbourne-Tasmanian trade contributed some 220,000 TEUs and some bulk freight movements; which equates to 11.5 per cent of the port's total volumes in 2004/05.

From Melbourne, freight is often forwarded by rail or road to other mainland states, such as New South Wales, Queensland and South Australia.

Therefore, in addition to sea freight and port operators based in Victoria, benefits also accrue to freight forwarders and operators of land transport services between

Melbourne and other mainland capital cities from freight movements induced by the TFES. For instance, rail operators are well known to rely heavily on Tasmanian freight flows on the Melbourne-Sydney route.

Victoria and other States are also likely to benefit to the extent that any industries are able to increase levels of production due to the subsidy provided on southbound inputs into Tasmanian industries. In addition, mainland wheat producers benefit from the TWFSS by exporting higher volumes of wheat to Tasmania.

Consumers on the mainland are likely to benefit to the extent that any transport subsidies are passed on to consumers in the form of lower retail prices for goods transported from Tasmania.

Some industries may, however, be disadvantaged due to the fact that their competitors in Tasmania have subsidised transportation costs for access to mainland markets.

If the TFES were discontinued, some Tasmanian businesses may contract or relocate their businesses to other States. Mainland States may then incur lower retail prices (because of lower transport costs of local production) and reap the indirect benefits of industrial activity.

The Victorian Government considers the issue of firm relocation (in the absence of the TFES) to be a difficult issue to assess. It would need to be addressed on an industry and perhaps firm level basis, depending on factors such as transport costs, proximity to raw materials and consumer markets.

The broader issue of the relative importance of transport costs compared to other cost drivers such as production (labour and land) and energy costs would also need to be assessed in trying to ascertain the extent of relocation of Tasmanian businesses in the absence of the subsidy.

Finally, the mainland states will effectively be the major, although indirect, source of federal funding for the subsidies and will therefore incur the greatest extent of any deadweight losses to the economy resulting from the schemes.

It is understood that the Productivity Commission has outsourced general equilibrium modeling – to be conducted by the Centre of Policy Studies (CoPS) – for the purposes of quantifying these impacts. The Victorian Government supports this approach and the Productivity Commission's use of CoPS outputs to assess the costs and benefits of the TFES and TWFSS.

The broader issue of establishing the most sensible counterfactual is an important aspect of the Productivity Commission's analysis. Forming more than one counterfactual may be required to test the economic impacts of 1) removing the

subsidies altogether and 2) extending the subsidies in both directions. These issues are discussed below.

Impact on the Australian economy

The Victorian Government acknowledges that there are likely to be broader economic impacts resulting from the \$90 million per annum TFES program.

Deadweight (allocative) efficiency losses are one outcome likely to result from the subsidy scheme.

As mentioned above, the Victorian Government supports the use of general equilibrium modelling to explore the full extent of economic impacts attributable to the TFES and TWFSS.

4. Improvements to current arrangements

In the Victorian Government's view, there are some inadequacies in the current design of the scheme, relating to the particular structure and complexity of the current subsidy calculation arrangements, which create the potential for distorted incentives and related unintended effects.

Incentive issues under TFES

Under the current design of the scheme there is likely to be at least some scope for “gaming” by industry participants.

The source of the problem is that, under the current arrangements, there is a provision for TFES subsidies to be calculated based on actual door to door (bundled) freight costs, which can result in higher than intended subsidies being paid.

By way of illustration, where freight forwarding charges are higher than the current adjustment parameter of \$230 for ‘door to wharf’ or ‘wharf to door’ charges, the excess above \$230 is effectively subsidised at the specified marginal rate (either 100%, 75%, 50% or zero), as the calculation of *notional wharf to wharf disadvantage* (NWW) will necessarily include this excess. Thus, there is a disincentive to reduce land freight costs towards the \$230 allowance and an incentive to bundle them with the blue water sea freight charges.

Companies which are able to bundle total costs due to either vertical integration or contractual bundling with relevant freight forwarding companies would be likely to receive custom from shippers wishing to “game” the scheme to their advantage. The scheme is therefore likely to be inadvertently subsidising some land freight costs. This incentive problem is exacerbated by the fact that discrete elements of the freight task are not transparent on bundled bills, which in turn provides at least some potential for freight companies to inflate costs on any of the transport components.²²

A second issue with the current scheme is that it has the effect of weakening incentives to minimize ‘wharf to wharf’ freight costs within particular cost ranges. In particular, if any shipper were able to achieve a standard TEU wharf-to-wharf price of \$615.50 (\$335.50 + \$281) or less in a free market, in the subsidized market they would have no incentive to further reduce the price with the shipping company, as at that price point they are receiving a 100 percent subsidy.

²² Where there is either unilateral or scope for coordinated market power through either price fixing or tacit collusion

This circumstance would provide the shipping company with what equates to a regulated “price floor” and could effectively result in a direct handout from Government to shipping operators able to reduce costs below this price level. At levels above this price there remains at least some incentive (albeit as low as 25 cents in the dollar) to reduce costs negotiated with shipping freight operators.

Resolving incentive issues

Assessing the extent of the impact of these and other design related incentive issues would require a detailed analysis of applications for scheme subsidies and a survey of costs and prices in the relevant industry sectors. This is a matter for the Commission and the authority administering the scheme.

However, one possible means of addressing the unintended effect of subsidising land freight and other non ‘wharf to wharf disadvantage’ costs, should these be considered significant matters, may be to modify the subsidy to a **flat per TEU rate**.

In the Victorian Government’s view, there are at least three potential advantages of moving towards a flat rate subsidy:

1. eliminating the subsidy being inappropriately applied to costs other than ‘wharf to wharf disadvantage’;
2. reducing or eliminating application of the subsidy to freight tasks that are not being carried out at an efficient scale; and
3. reducing compliance costs of the scheme.

Under the flat rate subsidy all marginal (scale related) freight cost disadvantages would be incurred by the shipper. Having noted this economic advantage, the Victorian Government is aware that this potential change may also raise some equity arguments, as the flat rate subsidy would necessarily be calculated on the assumption that the shipper is able to achieve reasonable economies of scale.

If the flat subsidy rate per TEU is set too low, smaller scale shippers are likely to be at a disadvantage as they are unlikely to be able to achieve the lower rates which bigger industries are able to negotiate from shipping service providers. On the other hand, if the rate is set too high then large industries would extract disproportionate benefit from the subsidy and would have no incentive to negotiate prices below the subsidised level.

One way to potentially resolve this issue may be to periodically benchmark costs for sea freight tasks of similar distance and to apply some productivity factor to reduce costs between periodic reviews (ie an incentive based regulatory approach).

Administrative issues

In the Victorian Government's view, there are also various issues relating to the administration of the scheme which should be addressed.

Firstly, under Clause 22.3 of the TFES directions, claims submitted as long as two years after the date of shipment are accepted. This raises issues around accurate data collection, the ability to assess the performance of the scheme and reporting. There may also be some incentive to delay submitting claims, for example in anticipation of a parameter review.

Secondly, in preparing this submission, it has been difficult to obtain meaningful publicly available data sets which would enable the effectiveness of the scheme to be properly assessed. The Victorian Government believes that it would be in the public interest to ensure that more meaningful data was available in order to increase transparency and ready evaluation of the scheme against its stated objectives.

Finally, the Victorian Government believes that the annual parameter reviews, as specified in the Minister's Directions, are not currently undertaken in a transparent manner, nor are the calculations behind the parameters able to be independently verified or reviewed. It may be worth considering making some of the data relevant to the annual parameter reviews available to the public in order to increase the transparency of the TFES scheme.

5. Alternatives to current arrangements

The Victorian Government notes that the Productivity Commission may consider significant departures from the current TFES and TWFSS arrangements. This section canvasses two alternatives.

Likely impacts of removing subsidy

As with any substantial cost shock, at the margin, a complete removal of the subsidy scheme would be likely to have material impacts on business decisions in Tasmania. It would also have an impact on the Tasmanian economy, especially in the northern part of the State.

The most likely consequence would be downsizing or closure of some Tasmanian operations in competitive industries where Tasmania does not have a clear competitive advantage. In the vegetable industry, for example, which is a highly competitive global market, it would be likely for there to be at least some rationalisation of industry processing facilities. These processing facilities may in effect be relocated internationally, relocated to Victoria or New South Wales, or closed altogether.

The impact on other industries, such as wood and paper products, where Tasmania may have a clearer competitive advantage, is less clear.

Hence there is likely to be some loss of state production and associated loss of employment for Tasmanians in at least some of the industries which are current recipients of the schemes' subsidies.

The flow-on effects are likely to be significant in both economic and social terms. Lower levels of employment are likely to lead to lower consumption, and higher transportation costs for business are likely to be reflected in lower levels of investment and land values.

Further, the Tasmanian economy also currently benefits from having a broad based range of industries and employment. To the extent any industries were lost to the Tasmanian economy there may be some stranding of relevant skilled employees. As a result, there could be significant social dislocation whilst the Tasmanian economy underwent structural adjustment.

Exploring further development of the TFES

Apply TFES to southbound final goods

The AusLink national transport program is concerned with facilitating transport connectivity, equity and trade across the nation. Despite the relative magnitude of the Bass Strait freight task, and its significance nationally, Bass Strait has not been included as part of the AusLink network, as it is not land based.

However, the AusLink objectives clearly have some overlap with the goals being pursued through the freight subsidy schemes, particularly in the area of encouraging improved freight transport connectivity. Broader national transport objectives might therefore sensibly be pursued concurrently through both AusLink and the sea-freight subsidy schemes.

The AusLink White Paper identifies the following objectives for AusLink:

1. improves national and interregional connectivity for people, communities, regions and industry;
2. improves national, interregional and international logistics;
3. enhances national, interregional and international trade;
4. enhances health, safety and security;
5. is consistent with the obligation to current and future generations to sustain the environment;
6. is consistent with viable, long-term economic and social outcomes; and
7. is linked effectively to the broader transport network.

The Victorian Government has previously communicated its views on national transport policy in 2003 in response to the AusLink Green Paper. That submission emphasised the view that the focus of national transport policy ought to be to:

- increase the capacity and efficiency of key export corridors;
- reduce constraints on key interstate freight movements;
- improve regional access to the national transport network;
- reduce intermodal costs on interregional and regional freight; and
- ensure the national network is sustainable (financially, environmentally and socially).

The Victorian Government suggests that the most effective and equitable way to align the TFES and AusLink policies, and in the process replicate the same sort of transport and economic outcomes for Bass Strait as those sought for AusLink corridors on the mainland, would be to extend the subsidy to final goods in the southbound direction.

Extending the TFES to final goods in the southbound direction would provide Tasmanian consumers with access to goods at similar prices to mainland consumers (Tasmanians have historically paid in excess of mainland prices due to higher transport costs). In addition, lower retail prices would stimulate demand for mainland goods, thus providing flow-on benefits to mainland industry. Implementing the subsidy equally in each direction would also neutralise any distortions in the allocation and use of resources in Tasmania arising from the current scheme's emphasis on northbound freight.

The Victorian Government, therefore, recommends that the Productivity Commission explore the implications of extending the TFES to include final goods in the southbound direction.

6. Conclusion

The Victorian Government generally supports the roles played by the TFES and TWFS in addressing freight disadvantage experienced by Tasmania compared with mainland states.

However, whilst supporting the basic retention of the schemes, the Victorian Government suggests that consideration be given to a number of measures to enhance their transparency, cost-effectiveness and consistency with broader national policy settings.

Specifically, it is suggested that consideration be given to:

- clarifying the policy objectives of the schemes including in the context of AusLink national transport policies and other relevant state and Australian policy objectives;
- once the objectives have been clarified, assessing whether the schemes should be targeted at the regional economic development of Tasmania, specific industries, and/or consumers;
- applying subsidies equally in both directions to enhance synergies with AusLink policy objectives.
- assessing the most cost-effective way of making payments to overcome specified freight cost disadvantages, including giving consideration to a single rate subsidy per TEU to remove current distortions of incentives relating to land transport (door to wharf and wharf to door) and other costs; and
- assessing the current governance and administrative arrangements for the schemes, including data collection and reporting functions, to ensure that in future the performance of the schemes in meeting their objectives is better able to be assessed in an open and transparent way.

A Case study: the vegetable industry

The majority of vegetables in Tasmania are grown in the Mersey-Lyell region. The two largest operators in Tasmania are Simplot Australia Pty Ltd and McCain Foods (Aust) Pty Ltd. Simplot Australia has processing operations in New South Wales, Victoria and Tasmania. Its reported revenue is in excess of \$740 million. It exports to various countries in the region with the major recipients including New Zealand and Japan.²³ In Australia McCain's has processing operations in Tasmania and Victoria. Globally, however, it has 55 production facilities on six continents.²⁴

Both companies run processing facilities and contract for the crops grown by local farmers. There are also a number of small operators who supply fresh vegetables.²⁵

According to the Australian Bureau of Statistics the value of the Tasmanian vegetable industry was approximately \$179.5 million in 2003-04.²⁶ This represented approximately:

- 7.6 percent of the value of national production of vegetables;²⁷
- 20.9 percent of Tasmania's agricultural production; and²⁸
- 3.7 percent of Tasmania's Gross State Product.²⁹

²³ From the Simplot website

²⁴ From the McCain's website

²⁵ "Agricultural supply- vegetables", see <http://www.iris.tas.gov.au>

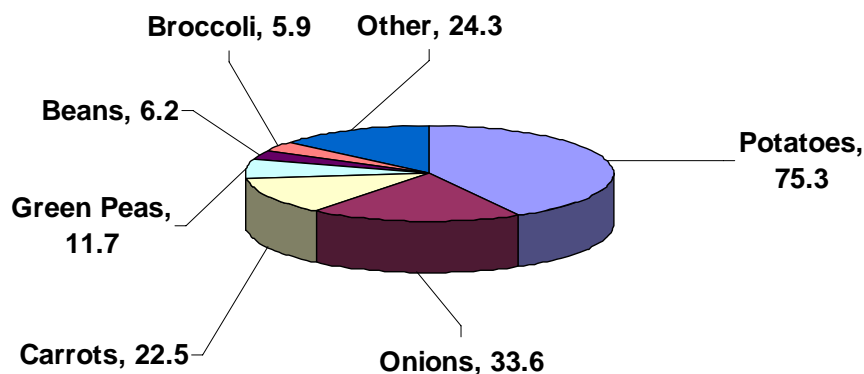
²⁶ Australian Bureau of Statistics, *Value of Agricultural Commodities Produced*, Catalogue Number 7503.0, 2003-04.

²⁷ Ibid

²⁸ Ibid

²⁹ Ibid

Chart 6 **Size of Tasmanian vegetable industry in 2003-04, by type of vegetable (millions)**



^a Data source: Australian Bureau of Statistics, *Value of Agricultural Commodities Produced*, 7503.0, 12 September 2005

This total includes produce which is sold locally, on the mainland and exported (New Zealand and Japan). Hence it is difficult to precisely determine from ABS data alone what the likely value of vegetable freight is being shipped to the mainland without specific data from the major companies operating in Tasmania.

The level of exports from the broader Australian vegetable industry was \$164 million in 2004/2005.³⁰ This was down five percent on the previous year. Additionally imports in the vegetable industry in the same year were \$326 million. This trend demonstrates the increasing degree of international competition to supply vegetables to the Australian market as well as internationally. Indeed in May 2005, McDonalds, one of Simplot's major customers, halved its contract with Simplot, instead turning to imports of potatoes from New Zealand.³¹

The total value of subsidies under the scheme for the vegetable industry in 2003/04 was \$18,633,792.³² The total weight of vegetables under the scheme was 344,616 tonnes.³³

In the Victorian Government's view, this means that the transport subsidy as a percentage of total production value from Tasmania to the mainland is likely to lie in the range of 12 and 20 percent. This is significant relative to the value of production.

³⁰ Ausveg, Fast Facts, August 2005, www.ausveg.com.au

³¹ "Agricultural supply- vegetables", see <http://www.iris.tas.gov.au>

³² Centrelink, *Tasmanian Freight Equalisation Scheme, Statistics*, 12 months ending 30 June 2003.

³³ Ibid

Some broad lessons from the vegetable industry are likely to include:

- the TFES represents a significant proportion of value of Tasmanian production supplied to the mainland;
- there is strong competition from imports to supply vegetables to mainland Australia (and internationally);
- demand for vegetables is highly elastic (consumers are highly responsive to price changes); and
- removing TFES would provide a significant cost shock to the industry and would likely lead to the loss of employment and perhaps even closure of some Tasmanian processing operations.